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Accounting News And Trends

Guaranties, Subordinations and the Credit Grantor

Those accountants whose clients engage in extensive credit transactions will find useful a handbook on "Guaranties of Debts and Subordination of Claims" which may be purchased from the New York Credit & Financial Management Association. With the tightening of credit and money and the consequent selectivity of credit risks by merchandise suppliers and lending institutions, there has come an increasingly greater dependence upon the use of guaranties. Because of the numerous requests received by the Association, this handbook was prepared to give more detailed information concerning the relative value and protection afforded to credit grantors through the use of guaranties and subordinations.

Since it is designed to be used as a guide by the business executive in his everyday work, it is written in simple, easy to understand language. It is, of course, not a compendium of all the laws on guaranties but is a useful generalized statement which adequately meets its two-fold objectives:

1. To analyze some of the salient provisions of the guaranty and explain their importance as a means of protection to the credit grantor holding the guaranty; and

2. To enable the business executive to avoid the common pitfalls which may render the guaranty worthless.

ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, CPA *and member of the New York Bar. He is presently serving as a member of our Society's Committee on Legislation.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

How Much Honesty Insurance?

"How To Determine the Correct Amount of Fidelity Coverage" by Mr. Peter A. Zimmerman in the CREDIT EXECUTIVE (June 1958) explains how to avoid underinsurance against fidelity losses.

A special subcommittee of the New York Credit and Financial Management Association assembled data on hundreds of losses extending over a ten-year period. In addition to the amount of the loss, information was gathered about the period of concealment by the defaulter, the amount of the bond, current assets, number of employees, and sales or gross income. The committee sifted these answers and sought some factor that might be used as a base for a guide to the amount of coverage required. No single factor proved to be adequate but a combination of current assets and annual sales or income provided a formula of general application.

After much experimentation it was found that a certain percentage of each of these factors represented an exposure index. The exposure index was found to be: 20 per cent of current assets and 10 per cent of annual sales or income. Where a separate figure is available for the value of the goods on hand, the exposure index can be further refined by applying 5 per cent to this figure and 20 per cent to the remaining

current assets. The total of the figures produced by these percentages constitutes a so-called "exposure index."

The committee next devised a graduated "Table of Exposure Index Amounts" and related it to suggested minimum bond amounts. For example, where the exposure index figure is between $1,000 and $25,000, the suggested bond amounts are between $15,000 and $25,000. The table runs up in 31 steps to an exposure index of one and a half billions which, incidentally, requires a bond of $5 million.

The bond amounts suggested by the formula are definitely minimum amounts but in testing the formula it was found that it produced full protection in 95 per cent of the cases studied. For more information about this problem as well as examples of the formula's application, accountants can secure a booklet "How Much Honesty Insurance?" from the New York Credit & Financial Management Association.

Unaudited Statements

Some of the comments in "The Small Client and Unaudited Statements" by Mr. E. S. Mactier in THE CANADIAN CHARTERED ACCOUNTANT (June 1958) are of real interest to American accountants. Unaudited statements were the subject of Research Bulletin No. 13 issued in 1957 by the Canadian Institute of Chartered Accountants and the article discusses points raised in this bulletin.

The author believes that there are two reasons for the increased use of statements prepared without audit:

1. It is not always possible or necessary for the auditor to conduct an audit in order to prepare interim financial

statements for a small client. It is unreasonable to expect the practising accountant to express unqualified opinions on all statements which he is required to prepare for interim purposes.

2. Because of competitive pressure, the small client needs financial statements for management decisions and, for the most part, these need not be audited. The small client often employs the public accountant more as his confidential financial advisor than as an auditor and many small clients deem the advice received more important than the audit of the accounts. Assistance in the preparation of unaudited statements and their oral interpretation to management may suffice to give the client all the financial information he requires.

Sometimes when the accountant is unable to carry out a full-scale audit, the client may ask him to state what work has been done. If the work done is itemized in the comments accompanying the statements, the accountant must not give the impression that the comments are an expression of opinion on the statements. It would be more important to mention audit procedures which have been omitted in order to point out the limitation of the examination. In addition, of course, a definite denial of opinion should be included.

In discussing the issuance of statements on plain paper without a disclaimer, the author points out that the accountant has no way of protecting himself against misrepresentation by the client toward third parties. On inquiry, he must acknowledge responsibility appropriate to his professional contribution in the preparation of the statements. The Research Committee of the Canadian Institute is emphatic in stating that the use of plain stationery in no way absolves the accountant from any responsibility that he might otherwise have in the circumstances.

It is interesting to note that the pro-

fessional standards which have been adopted in this regard are more restrictive than the law requires since it is doubtful if the accountant could be held responsible to third parties for financial statements with which he was not identified and on which he prepared no report. Presumably, he could only be held accountable to his client for work which he acknowledged having performed.

The author suggests that if the accountant knows that the unaudited statements will be submitted to third parties with a substantial interest at stake and also if the client is restricting the scope of the examination, the accountant must decide whether to refuse the engagement if he cannot convince the client of the need for an audit.

Return on Investment

Aids in determining when capital expenditures will be justified are set forth by Edward G. Koch in "The Use of Management Yardsticks for Capital Expenditure Decisions" (THE CONTROLLER January 1958). The author points out that while the concept of cash pay-back (i.e., the savings within an indicated period of time resulting from the investment) is common among many companies, the medium- and large-sized companies tend to adopt both return on investment and cash pay-back as benchmarks.

One problem arises in determining the amount of the cash pay-back. The majority of companies consider cost savings or earnings after taxes but before depreciation as the appropriate amount. Actually this cash recovery measurement is primarily a liquidating concept for conserving cash rather than judging profit efficiency. It can, however, be used for a rough screening of capital expenditure proposals and also for risky investments where the rate of depreciation is particularly difficult to determine. A survey of McGraw-Hill indicates that over 80 per cent of all manufacturing companies expect to get their

money back in five years or less, and more than a third of them expect their money in three years or less. However, the basis of pay-back depends upon the specific definition of cash recovery which was not stated by the responding companies.

In a highly competitive economy the return-on-investment yardstick helps management in its task of employing additional capital at a satisfactory rate of return. If a company is merely expanding at declining rates of return on investment, it will eventually run into difficulties. Accordingly, many companies establish a standard return on total assets employed and use this guide not only for investment decisions, but as a measure for the profit efficiency of company units.

The author emphasizes the importance of watching the use made of investments and suggests the following computation to determine return on investment:

1. Compute turnover. Sales divided by total investment (i.e. working capital plus permanent investment.)

2. Compute percentage that earnings bear to sales.

3. Multiply item 1 by item 2 to determine rate of return on investment.

In summing up, the article urges that the modern management of capital expenditures requires a return-on-investment yardstick in addition to the pay-back standard. It is all the more important to use both because the new investment may entail other assets in addition to the capital expenditures. Moreover, it must be certain that these are always taken into account in all capital project proposals. All too often, it is forgotten that other assets, especially additional working-capital items are involved in the project as a total gross investment, not only the capital expenditure itself. It is clear that investment decisions should encompass the project worth on the basis of *added* return on *added* investment.

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Letters to the Editor

Punched-Card Machines for Small Business

Things to Come and Present Realities

The Adirondack views of Leonard Houghton have proven him to be one of the astute observers of our times. His five point predictions for the next twenty-five years will, I am sure, become realities during that period and lend further proof of his wisdom.

As a case in point, we know of at least one of the predictions which has already become a reality. Number (2) in his list was "punched-card machines for small businesses—a machine to accumulate all the general bookkeeping currently for each month."

Just a week ago, a demonstration was presented of a comparatively inexpensive tape adding machine which records all monthly transactions by date, reference number, general ledger account number and amount. The operator of this adding machine need not have a knowledge of bookkeeping, and with a few hours of practice can operate this machine at the rate of more than 200 transactions an hour. And that is all the manual work required to obtain complete journals, subsidiary ledgers, general ledger, trial balance and printed financial statements from an independent tabulating service. The machine rents for one dollar per hour and the cost of processing 200 transactions and producing monthly financial statements is eight to ten dollars.

We ran a test of the operation ourselves. One of our staff men entered, posted and took a general ledger trial balance for one-hundred check disbursements and journal entries. It took him several hours. He then entered the same material on the machine in twenty minutes. Accuracy of the dollar amount was controlled through the adding machine tape totals.

Though the extent to which this machine operation can be applied to general bookkeeping remains for experiment and the ingenuity of accountants to develop in years to come, Leonard Houghton's idea of punched cards for small businesses may be more of a reality than he dreamed of when he wrote of things to come.

DONALD A. SCHWARTZ, CPA
(Greene and Schwartz)
Syracuse, N. Y.

Welfare Funds and the Mystery of Literary Endeavor

I recently was engaged to audit the welfare fund of a local labor union, and I want to express my thanks and appreciation for the assistance that I had from an article by Raymond Buchbinder, CPA, in the February 1958 issue of your magazine.

I have been a CPA since 1925 and it has always remained a mystery to me how these fellows who write the articles seem to know all about the subject.

THEODORE COREY, CPA
Newark, New Jersey

Advice on the Preparation of Interim Reports

It appears to me that the younger members of our profession and perhaps new practitioners, might benefit from some comments with respect to interim reports. Therefore, I am submitting the following for your perusal and if deemed worthy, for publication in the "Letters to the Editor" Department.

Avoid the indiscriminate use of any one type of report. Develop and pre-

pare the report that you and management deem most meaningful and informative. The client will best benefit only if we present his financial condition and operating results in the form that is both acceptable and comprehensible to him. This can only be achieved through consultation and consideration of the nature of the business, his objectives, and the uses to which your report will be put. But regardless of the type you prepare, the contents and presentation have a definite bearing as to whether or not the maximum value will be obtained. The inclusion of some of the following should help attain that goal.

The interim report should classify and categorize accounts and items in the same detail as in the year-end report. By doing so, we eliminate the need for management or the credit grantor to realign or recast our interim report in order to make it comparable with the annual statement.

In those instances where the report is solely for management's use, you should not hesitate to vary the conventional and standard format of the balance sheet and statement of profit and loss if, in doing so, you are enabling the client to derive the data he desires. For example, the balance sheet can present the current assets minus the current liabilities, leaving a balance to be captioned working capital. The profit and loss statement can contain a cost of

sales section which includes only those items which management considers in its costing method.

Comparative statements are extremely beneficial to the accountant and his client since they will highlight trends and changes. Consider the inclusion of comparative cumulative and comparative short periods. However, a word of caution is in order; make certain that your short periods are truly comparable. For example, in the retail field, Easter may be in March one year and in April in another year. Other seasonal industries may present similar situations.

Operating statement costs and expenses expressed either as a percentage of sales or on a unit basis can be very revealing. A variation in the dollar amount of costs or expenses of comparable periods is meaningless unless taken in relation to the sales of each period. The use of percentages will provide proper criteria for analysis.

The balance sheet can be compared with that of the same date in the prior year, the same date in previous month, or with that of the beginning of the fiscal year. In doing so, we will reveal variations in working capital, increases or decreases in fixed assets, the liquidity of inventory and accounts receivable, the rate of collection of the accounts receivable, etc. As in the operating statement, balance sheet ratios will also highlight the trends of your comparisons.

Have you considered adding narrative comments on the financial condition, on the operations, or on some other facet of the business cogent to your audit?

The provisions of Bulletin No. 23 are just as applicable to reports prepared as a result of an interim audit as to year-end reports. The disclaimer can be incorporated in the letter of transmittal, if one is prepared, and reference to the "Letter" made on the balance sheet and on the operating statement. If no letter of transmittal is prepared, the

disclaimer should be set forth on the balance sheet and on the statement of profit and loss. This disclaimer of an opinion need not assume a standardized form. Any expression which clearly states that an opinion has been withheld and sets forth the reasons why, will be in compliance. The following are illustrative of the wording of appropriate disclaimers.

Where no letter of transmittal accompanies the report:

> The above balance sheet and attached profit and loss statement were prepared as the result of monthly examinations . . . However, since the assets and liabilities were not confirmed by direct correspondence and the inventory was submitted by the management, no opinion can be expressed in connection therewith.

Where a letter of transmittal is prepared, the disclaimer is usually inserted as the last paragraph.

> This interim report . . . has been prepared as a result of monthly examinations . . . However, since we did not verify the assets or liabilities by direct correspondence, and were not present at the physical inventory taking, we are unable to express an independent opinion in connection therewith.

A note would then be inserted on the bottom of each of the financial statements indicating that the statement is subject to the foregoing comments which are made a part thereof.

Perhaps some of you are thinking about your client's reaction and how it might disrupt your relationship of long standing and that reports with this statement would not be acceptable to credit grantors. The problem, if any, is one of education of the client and the credit grantor and conceivably of our fellow accountants. It is incumbent on us, if we are to maintain a high professional level, to comply with this pronouncement. The first step toward this accomplishment, is to so familiarize yourselves with the rule that you will be able to explain its purposes and desirability to all affected.

NATHAN S. LUFT, CPA
New York, N. Y.

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 677 Fifth Avenue, New York 22, N. Y.

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CPA, partner in firm, 35, seeks position leading to acquisition of practice or partnership interest. Box 1482.

Financial Executive, CPA, law degree, over 25 years extensive experience, public, private, presently employed assistant comptroller manufacturing company, progress blocked, seeks more challenging opportunity, excellent references, $10,000. Box 1483.

Secretary, statistical typist, CPA 10 years experience, permanent, IBM, excellent references. Box 1484.

Statistical Typing, work neatly done in my home, seven years experience. 19 Oakwood Avenue, Merrick, L. I., N. Y., FR 9-6188.

CPA, N. Y., 28, married, five years public accounting experience, desires interesting position with possibility of advancement, will relocate, salary requirement $8,000. Box 1486.

CPA, nine years thoroughly diversified large and small firm experience, available per diem or engagement basis. Box 1494 or OL 4-2382.

CPA, age 30, Society member, eight years diversified public accounting experience, seeks permanent position with public or private firm. Box 1497.

Young, N.Y.U. accounting graduate, seeks part-time employment, available Monday through Friday after 5 p.m. and all day Saturday. Phone IN 1-6381.

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CPA, tax accountant, LLM taxation, experienced tax research, planning, protests and petitions, available per diem N. Y. C. area. Box 1506.

CPA, AICPA, NYSSCPA, MBA, 16 years public accounting and tax experience, desires position in tax department of CPA firm, available 2-3 days week. Box 1507.

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CPA, 33, 9 years public experience seeks association with individual practitioner offering partnership opportunity in other than Metropolitan N. Y. Box 1491.

CPA, gross about $15,000, has few days available, desires association with practitioner, aim joint administration, mutual benefits and eventual partnership. Box 1492.

CPA, individual practitioner offers share of office with other CPA. Apply room 1807, 505 Fifth Avenue, N. Y. C.

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CPA, 34, extensive experience, having quality practice, seeks merger with CPA firm interested primarily in associate able to handle all top level functions. Box 1500.

Office Space, in CPA suite, Grand Central area, secretarial service, Bruning reproducing machine, excellent environment, MU 2-7168 or Suite 1210, 41 East 42nd Street, N. Y. C.

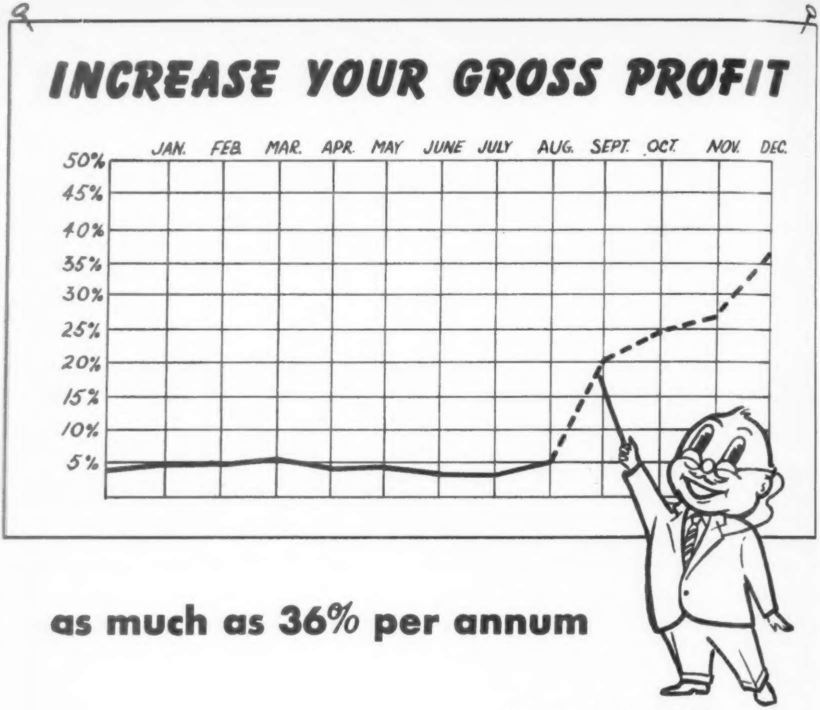
CPA, attorney, 34, $15,000 gross, experienced managing larger practice, wishes to associate with CPA or CPAs aware of importance of strong organization progressively oriented. Box 1501.

CPA, 31, $5,000 practice, seeks opportunity with other practitioners to merge, manage or purchase, excellent background, references. Box 1502.

CPA, attorney, tax man, former revenue agent and technical adviser, specializing exclusively in tax and estate planning, research, litigation, audits and returns, seeks association with accounting firm in need of part-time tax services on mutually satisfactory arrangement. Box 1503.

CPA Firm, small, well-established, will operate, manage and assume tax burdens for practitioner, association or purchase, continuity and coverage provided under feasible working arrangements. Box 1504.

CPA, desires office, preferably in midtown Manhattan. Box 1505.



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The President's Page

Auditing Standards

Under date of April 28, 1958, the President of our Society addressed a communication to our membership calling attention, first, to the fact that the American Institute of Certified Public Accountants had adopted a new rule of professional conduct embodying the substance of Statement on Auditing Procedure No. 23 issued by the Institute's Committee on Auditing Procedure and, second, to the adoption by our Society of the principles of Statement No. 23 in April, 1953. Although the communication was directed primarily to Standard of Reporting No. 4 of the generally accepted auditing standards, it may be regarded, in part, as a reaffirmation of the overriding importance of these standards.

The term "auditing standards" has assumed real meaning to the professional accountant. As indicated in the following excerpt from "Generally Accepted Auditing Standards," the special report issued in 1954 by the AICPA's Committee on Auditing Procedure, it embraces general competence and qualifications of the independent accountant, proper performance of services, and adequate reporting on the results of such services.

GENERAL STANDARDS

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

STANDARDS OF FIELD WORK

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

STANDARDS OF REPORTING

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.

The foregoing standards represent fundamental rules for the guidance of our profession. They govern our relationship with our clients and the public. Every issue of our professional magazines is devoted primarily to the advancement of our standards. The work of our Committees is devoted primarily to the improvement of professional competence.

During the past year several articles in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT written by representatives of credit groups have recited instances of failure on the part of some independent accountants to observe fully the generally accepted auditing standards, particularly the standards of reporting. Our Committee on Professional Conduct reports that very few complaints are filed with them on the subject of lack of compliance with the standards of auditing or reporting. While it is believed that the number of violators is small, even a small number can cast a bad reflection on the profession as a whole. For this reason, we must, through education, policing, or by other means, seek to eradicate completely faulty reporting practices. A major concern is, of course, Statement No. 23 and the need to eliminate any question on the part of the readers of reports as to the extent of the responsibility assumed by the accountants.

A recent issue of the Robert Morris Associates' Bulletin contains this statement: "Since an accountant adhering to Rule 19 and to the principles of Statement No. 23 will not issue a report without an expression of an opinion or a disclaimer, bankers should understand that a report without an opinion or disclaimer is of little value and should not be accepted for credit purposes." The practical consequences of failure to fully conform practices with auditing standards are becoming sharply apparent. In view of the fact that our Society has adopted the principles of Statement No. 23, and, more particularly, since there has been a special communication to our members regarding this subject, there can be no excuse for non-compliance with these principles. One cannot escape the conviction that non-compliance constitutes a violation of our rules of professional conduct and should be treated as such. Our standing as a profession requires prompt and diligent attention to the universal observance of these standards.

HOWARD A. WITHEY,
President

A Symposium

Accounting Phases of Estate Planning

Foreword

By Benjamin Grund, CPA

Estate planning is an area in which the certified public accountant has proven to be a qualified and important member of a team, which is generally headed by the family attorney and frequently includes the trust officer and the life insurance underwriter.

The CPA by virtue of his intimate and current knowledge of the financial condition of his client can consider and discuss with the client steps that may be appropriate to properly plan his estate. Tax considerations are not always the prime consideration. Family problems and the preservation of values generally are of first importance. The coordination of these, with a weather eye upon the impact of taxes, both estate and income, can spell the difference betwen retention or sacrifice of values.

The members of the estate planning team, working together with the goal of preserving both family and financial values, can be of inestimable benefit to their clients. And the CPA, by properly assembling and analyzing the fundamental financial data necessary for the solution of the problem, can play a very important role. Through such participation, the CPA can also cement his relationship with the younger generation which will succeed to the reins of business upon the creation and settlement of the estates of his present clients.

Many of the questions that arise in estate planning were discussed at the December 1957 General Meeting of the New York State Society of CPAs and at its 1958 Annual Conference by a panel of members of the Society's Committee on Estate Planning. The questions presented and the answers given, which are confined in certain instances to the fundamentals of the problems discussed, have now been reduced to writing and should be of interest to the readers of The New York Certified Public Accountant.

Benjamin Grund, CPA, *formerly a vice president of our Society and chairman of its Committee on Federal Taxation, is currently serving as chairman of the Committee on Estate Planning. Mr. Grund is a partner in the firm of Seidman & Seidman, Certified Public Accountants.*

Ed. Note. Grateful acknowledgment is extended to Henry Brach, CPA, for sharing with the chairman of the Committee the task of reviewing this article prior to its submission for publication. Mr. Brach is a member of our Society's Committee on Estate Planning, a former member of the Committee on Federal Taxation, and a partner in the firm of Brach, Gosswein & Lane, Certified Public Accountants.

Accounting Phases of Estate Planning

Valuations, Gifts and Income Tax Savings

By Oscar Hanigsberg, CPA

Gift and Income Tax Savings Features

In seeking to combine gift and income tax savings with sound estate tax planning, maximum use of all exclusions and exemptions is the most elementary and probably the most generally useful approach. These include the $3,000 annual exclusion of gifts of a "present interest" to each donee, the $30,000 lifetime exemption for all gifts made by a donor, and the $60,000 estate tax exemption. Where gifts are made by a married donor, exclusions and exemptions may be doubled by the spouse exercising the required consent on the gift tax returns of the donor. Gifts remove property from the maximum estate tax bracket to the minimum gift tax bracket, besides providing the advantage of gift tax rates which are 25 per cent lower than estate tax rates. Gifts of income-producing property have the further advantage of removing income from the maximum income tax bracket of the donor to the lower tax bracket of the donee, and may bring into play another income tax exemption. However, personal considerations must not be overlooked and the donor should not give property away unless he is sure he has enough left over.

The Use of Higher Optional Values

With the recent sharp fluctuation in security values, we have been taking it for granted that the optional value should be used to compensate for lower values a year after death. Is it ever desirable to use higher optional values during rising markets?

Valuation of property for estate tax purposes determines the income tax basis of the property in the hands of the subsequent owner. Consequently, where the property has a higher value on the optional valuation date, it may be desirable to pay a greater estate tax in order to secure a higher basis for purposes of subsequent sale or depreciation. Where property passes to a spouse, the estate tax resulting from higher valuation may be partly offset by an increased marital deduction. The Internal Revenue Service agrees that the optional value may be either lower or higher than the value at date of death (Rev. Rul. 55-333). The Service, however, denies the use of optional values where the gross estate is less than $60,000 and no estate tax return is required (Rev. Rul. 56-60).

Election to Deduct Administration Expenses and Losses

Administration expenses and losses are allowable as deductions either on the estate tax return or on the income tax return of the estate, as *finally* elected. It may be more practical to first claim the deductions on the estate tax return and then make the final election at the time of filing the income tax return when it is possible to determine which deduction provides a more beneficial tax result. The Service has ruled (Rev. Rul. 53-240) that the subsequent deduction on the income tax return will not be precluded by the prior deduction on the estate tax return if the deduction had not previ-

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Oscar Hanigsberg, CPA, *a member of our Society's Committee on Estate Planning, is a partner in the firm of Hanigsberg & Delson, Certified Public Accountants. Mr. Hanigsberg formerly served on the Committees on Federal Taxation and New York State Taxation.*

ously been *allowed* on the estate tax return and the taxpayer makes clear, by statement and waiver, that the same amount is not *currently* being claimed as a deduction on the estate tax return.

Late Gifts

It is never too late to make an inter-vivos gift. Even if the gift is held to be in contemplation of death, there would still remain the advantage that the gross estate is reduced by the amount of the gift tax. In addition, there is a credit against the estate tax for the gift tax paid. And if the taxpayer does survive for three years, the gift cannot be included in the donor's estate. Even if the taxpayer dies within three years from the date of the gift, it is the motive of the gift, not necessarily the health of the taxpayer, that is determinative of the issue of contemplation of death.

Paying Estate Taxes with Government Bonds

There is no provision in the law allowing a discount if an estate tax is paid in advance of the due date. It is possible, however, to purchase at a discount certain U. S. government bonds which will be accepted at par in payment of the federal estate tax. The bonds must be owned by the decedent at the date of death. If acquired by the estate subsequent to death, they may not be so used. Since it is not always possible or practical to discuss with a taxpayer, in a critical stage of health, the acquisition of U. S. bonds to save federal estate taxes, it may be desirable for a representative to have a power of attorney authorizing the purchase of such bonds in the name of the taxpayer.

Estate Planning for Corporate Liquidation or Sale of Securities

Estate planning should be considered before liquidating a corporation or selling securities. On death, the stock owned by the taxpayer receives a stepped-up basis equal to its fair market value at time of death or the optional value, previously discussed. Liquidation of a corporation, or selling its stock shortly thereafter, will result in capital gain only to the extent that the amount received exceeds the estate tax value. If there is a choice as to securities which should be sold before death, it is preferable to sell those with a higher basis in relation to value and to retain those with a comparatively lower basis.

If securities are to be sold at some time before death, it may be advantageous to make gifts of these securities to those members of the family who are in lower tax brackets than the donor. This is true because the effective tax will be smaller even though the aggregate capital gain is the same. A donor in a high tax bracket pays 25 per cent of his long-term capital gain. A donee in the 20 per cent bracket pays only 10 per cent (20% of 50%).

Family Planning and Short-Term Reversionary Trusts

Basically, a short-term reversionary trust is an income tax planning device. Where property is transferred in trust and the term of the trust is a period which is, or which reasonably may be expected to be, not less than 10 years (except where it is measured by the life of the income beneficiary, in which event no fixed or reasonably expected term is necessary), the income produced by the property is taxed to the trust or beneficiary rather than to the donor. If the beneficiary is a qualifying charitable organization, the term of the trust must exceed only two years. A gift, if made to other than a qualifying charitable organization, must be reported for gift tax purposes. The amount of the gift is the excess of the value of the

property over the present value of the interest in the property to be recovered by the grantor after the term of the trust. The Service publishes a table which is used to determine such value. The table shows that the amount of a gift to a trust for 10 years with reversion to the grantor is about 30 per cent of the value of the property transferred.

It should be noted that where the income of a trust may be used to discharge the legal obligation of the donor to support a dependent, the income is taxable to the donor to the extent so used. Whether such legal obligation includes such items as a college education for a child is a question of local law which an attorney should resolve.

If a taxpayer desires to contribute more than 30 per cent of his income to a charitable organization, he can do so and effectively eliminate from his income the full amount contributed through the medium of a short-term trust. The Code also permits a deduction, in the year the trust is established, for the value of the income interest contributed if the donor retains no more than a 5 per cent reversionary interest in the property donated to the trust, thereby effecting a double deduction. The 5 per cent reverter requirement can be avoided by providing for the trust principal, instead of reverting to the grantor, to go elsewhere, such as to a child or other family member. The Technical Amendments Bill, now pending in Congress, proposes to eliminate the double deduction in this case. There is also in the wind a proposal to allow only a single exemption for multiple trusts having a single beneficiary.

Use of Trust Income for Grandchild's Support

Where a trust is established by a grandfather for his grandson and the trustee applies income to satisfy the legal obligations of the grandson's father, what is the effect on the father? Where the father has this power, as trustee or otherwise, the father is taxed on such trust income to the extent that it is applied to satisfy his legal obligations. Moreover, the Regulations (Section 1.662(a)-4) hold that the father is taxable where his legal obligation is satisfied even if he himself has no power to apply trust income for this purpose. This is the same position that the Service took prior to the 1954 Code. Cases under the 1939 Code have held against the Service on this point.

Determination of Property Values

The estate tax as well as the gift tax is computed on the value of the property. Let us assume that an internal revenue agent is proposing to value the decedent's property in the following manner:

1. Solely owned merchandising business—on the basis of the balance sheet of the business plus goodwill based on the previous five years' earnings;

2. Fractional interest in jointly owned real estate—on the basis of his share of the appraised value of the real estate;

3. Controlling interest in a real estate corporation engaged in selling subdivided lots—on the basis of the appraised value of the lots.

The following criticisms can be offered with respect to this procedure. Apart from the question of whether the book value represents actual value and addressing this discussion to the issue of goodwill, it is debatable in proposal No. 1 whether prior earnings resulted from goodwill, or from the personal efforts, judgment and contacts of the decedent. Prior earnings justify a finding of goodwill only to the extent that the earnings derive from the reputation, location and

going value of the business. A style business, such as dress manufacturing, is greatly dependent on present management and may have little or no goodwill. I would oppose a valuation on the basis proposed by the agent.

As for proposal No. 2, many cases hold that a fractional interest is worth less than the proportionate part of the whole interest, because of absence of control.

In the case of proposal No. 3, owning the lots indirectly through a corporation is less valuable than owning the lots directly. Should the corporation have to pay a tax on the gain from the sale of the lots, the estate could realize only its share of the net amount left after corporation income taxes.

Corporate Flexibility

In any estate planning considerations relative to the organization or reorganization of a corporate business, attention should be given to corporate flexibility. Creation of stock of different classes may facilitate estate arrangements such as gifting away value and income, while retaining control. Conversely, this technique can be employed in retaining present values while parting with future appreciation at a minimum gift tax cost. And care should be taken at the very outset to avoid the effect of Section 306, the so-called "hot stock" section.

This may also be the time to have a weather eye on qualification under Section 303 which makes redemption of stock to pay estate taxes free from tax as an ordinary dividend. To qualify, the value of the stock owned by the estate must be more than 35 per cent of gross estate or 50 per cent of taxable estate. For purposes of this rule, where the estate owns two or more corporations, the stock owned will be considered as the stock of one corporation, but only if the estate owns more than 75 per cent of the value of the outstanding stock of each corporation. The share of the estate in future appreciation and in control of the corporation can be preserved if the stock to be redeemed is preferred stock, the estate retaining its common stock.

Joint Ownership of Property

Is it wise for spouses to own property such as real estate or a bank account in their joint name? From the point of view of estate tax, the arrangement has its drawbacks. The value of the entire property is included in the gross estate of the first spouse to die unless the survivor is able to prove money contribution to the purchase of the property, or deposits in the bank account. The amount of the proved contribution of the survivor is excludable from the gross estate of the decedent. Proof of contribution can be a very difficult practical problem.

Is any gift tax due upon the division of jointly owned property? Section 2515 of the Code provides that where spouses acquire real property as joint owners, regardless of who supplied the purchase price, no gift tax liability will arise at the time of purchase unless they so elect. But when the property is sold, a gift tax liability will arise unless the proceeds are divided in the ratio in which the purchase price was originally furnished by the spouses. This rule applies only to interests in real property.

Minor's Stock Registered in Parent's Name

The Service has ruled on the various phases of the tax treatment for income, gift and estate tax purposes of stock owned by a minor and registered in his parent's name as custodian. The principles are as follows:

1. Income will be taxed to the minor.

2. For purposes of gift tax, the $3,000 exclusion relating to a gift of a present interest will be allowed.

3. If the donor of the stock is also the custodian, the stock will be taxable in the donor's estate. For this reason, it is desirable that someone other than the donor should be made the custodian.

Problems of the Businessman, the Professional Man and the Partnership

By William K. Carson, CPA

Additional Payments to Partner's Estate

In many cases, a professional man or a businessman will carry on the practice of his profession or the conduct of his business as a member of a partnership. Assume that the partnership agreement provides that the estate of a deceased partner is to receive, in addition to the decedent's interest in the capital and earnings of the partnership up to the date of his death, a stated annual sum for a limited period. How are such additional payments to be handled in: (a) the final income tax return of the decedent, (b) in the estate tax return, and (c) in the income tax return of the estate?

It is clear that no part of these payments is includible as income in the final return of the decedent. Under the regulations they become distributions of income by the partnership and are treated as a share of the partnership income allocated to the estate to the extent of payments in each taxable year of the partnership. A complication is created where profits are not distributed until the year following that in which they are earned since the regulations do not allow allocation to the estate until the later year. The present value of such payments is probably includible as an asset in the estate tax return in accordance with the *Riegelman* case. However, one should be on the alert to try to distinguish a client's situation and bring it within the doctrine of the *Bull* case, under which income earned after death is not includible in the gross estate. It would seem that in order for the *Bull* case to apply it is necessary to show that the partnership agreement did not require payments to the estate, but merely gave the estate an option to accept a share of the partnership profits.

Reporting Income Where Partnership Year Differs

The taxable year of a partnership may differ from the taxable year of a partner. Suppose a partnership taxable year ends April 30 and a partner, who reports on the calendar year basis, dies on September 30. How shall his share of the partnership income for the period May 1 to September 30 be reported in the final return of the deceased partner or in the income tax return of his estate?

His share of the income up to date of death will be reported in the partnership return covering the taxable year of the partnership in which the decedent died. It will be included in the decedent's final return if the partnership's taxable year ends with his death and

William K. Carson, CPA, *a member of our Society's Committee on Estate Planning, formerly served on the Committee on Federal Taxation. Mr. Carson is a partner in the firm of Touche, Niven, Bailey & Smart.*

in the estate's return if the partnership's taxable year ends later. In the usual case the partnership's taxable year will not terminate for tax purposes as a result of death of a partner and thus the income will be included in the estate's income tax return. Even in the case of a two-man partnership, the regulations provide that, following the death of one partner, the partnership continues for tax purposes "if the decedent's estate or other successors in interest of the deceased partner continues to share in the profits or losses of the partnership business."

If the deceased partner shares in partnership income only up to the close of the month in which he dies, how is the income to be reported? In the case of a two-man partnership where the decedent's beneficiaries have no continuing interest in the profits, income will be reported in the decedent's last return because of termination of the partnership. In other cases the income is reported by the estate. If the income of the partnership includes long-term capital gains, the portion of the long-term capital gains which are allocated to the deceased partner will be reported as capital gains regardless of whether they are subject to tax in his final return or in the estate's income tax return.

Income in Respect of a Decedent

In the first year of the administration of an estate, income of the executors can be unusually high because of realization of partnership income or of other income in respect to the decedent, such as executor's or trustee's commissions, dividends declared prior to death, etc. Bear in mind that state laws governing decedents and their estates are not necessarily the same as the federal income tax laws with regard to many matters. For example, income accrued at death is corpus under state laws. However, in the case of a cash basis taxpayer, this accrued income is to be reported by the estate as "income in respect of a decedent." How is this class of income to be reported in the final return of the decedent and in the federal estate tax return and the federal income tax return of the estate? What can be done to minimize the tax on such income? Would distributions to beneficiaries be practical? How can a fiscal year be helpful?

Income "in respect of a decedent" is never reported in the decedent's final tax return. The present value of such income must, however, be included in the federal estate tax return. When received it must be included in the federal income tax return of the estate but a deduction is allowed for the portion of the estate tax applicable to such income. Thus, income tax is paid on the excess of the income over the estate tax paid with respect to it.

In the administration of an estate it will frequently be found that income is bunched shortly after the decedent's death as a result of earnings which have accrued to him but which remain unpaid at the date of his death. There are generally two ways of minimizing the tax on this income. One is to have a short taxable year which would terminate before all of this income is received and thus split the large amount into two taxable years. The other is to distribute a portion of the income to beneficiaries. If the estate should have substantial liabilities the right of the executor to make distributions which would minimize taxes might be questioned. Accordingly, it is wise, in helping a client plan his estate, to suggest to him and to his attorneys that, in drafting his will, they go as far as possible to authorize distributions of principal at an early stage in the administration of the estate since income in respect of a decedent will usually be principal rather

than income for fiduciary accounting purposes, as distinguished from income taxes.

Stock in a Close Corporation

It is often necessary to plan for a man whose principal asset is stock in a close corporation. Suppose a man is an officer and also a minority stockholder in a close corporation which does not pay dividends. He wishes to arrange that his executors may be able to dispose of the stock, or at least obtain dividends for the beneficiaries. How can he accomplish this?

There are a number of ways of providing for sale of corporate stock by the executors or obtaining income for the beneficiaries. One method is to provide for sale of all or a portion of the stock to the corporation on death of the owner. However, such a provision would be dependent on the existence of accumulated earnings from which the stock could be purchased. A possible solution is to provide for a sale of stock to the corporation in the event earnings are available or, if they are not, for conversion to a dividend-paying preferred stock. While one could provide for a purchase by other owners on the death of one, through a contract among the shareholders, such an arrangement might be undesirable since the remaining shareholders might be unable to make the purchase. If such a contract were assigned to the corporation which distributed money to the estate in fulfillment of the obligation of the remaining shareholders, the distribution would be considered as a dividend. Probably the best method of providing financing in such a case is through life insurance.

Tracing Assets Previously Taxed

Assume that a man dies, leaving all his property to his wife and son. The wife dies one year later, and the son two years later. To what extent is the property which the wife inherits from her husband includible in her estate and to what extent is the property which the son inherited from his mother includible in the son's estate? Is it still necessary to trace the assets previously taxed?

The estate tax law contains a very complicated provision designed to eliminate double taxation in a situation like this. In the case of the wife's estate the previously taxed property is included but a credit is allowed equal to the lower of (a) the tax actually paid in the husband's estate on the property transferred to her, or (b) the tax paid in her estate on an amount equal to the value of such property which was included in the husband's estate. In the case of the son, an identical computation is made. However, if the son received property from both his father and mother, it is necessary to aggregate these amounts and compute the tax attributable thereto in his estate. The total tax is then apportioned between the transfers received from the father and the mother. The allowable credit is then determined by comparing the son's estate tax thus apportioned with the taxes paid by the estates of his father and mother separately and adding the resulting credits.

While the 1939 Code contained a requirement for tracing assets from one estate to another in order to obtain the credits, this has been eliminated. Furthermore, where the deaths are separated by more than two years, there is a percentage reduction in the allowable credit.

Securities in Settlement of Monetary Legacy

A decedent left some securities which were valued for estate tax purposes at $100,000. His will provided for a monetary legacy of $150,000 which was discharged through the delivery of these

securities, which at the time of delivery had increased in value to $150,000. Does this result in taxable income to the estate? If so, what is the basis of the securities to the beneficiary? How can proper planning avoid the tax on the income?

The use of securities to settle a monetary legacy gives rise to gain or loss and in this case there would be a taxable gain of $50,000 to the estate. The basis of the securities to the beneficiary would be their value of $150,000 at the time of receipt. This tax could be avoided if the estate had other assets which had not appreciated which could be used to settle the $150,000 legacy. If it were actually the testator's intention that a beneficiary should receive the specific securities and he provided for a specific legacy of those securities there would be no gain to the estate on the transfer of the securities to the beneficiary. In this latter event, the basis of the securities in the hands of the beneficiary would be $100,000, the same as in the hands of the estate.

Installment Obligations

A decedent has sold certain real estate and had been reporting the gain on the installment basis. At his death, the installment obligation was not fully paid. How shall the executor handle the installment obligation and the collections thereon in the estate tax and income tax returns?

In the estate tax return the installment obligation should be reported at its fair market value. Collections on the obligation give rise to income to the estate. The computation of the amount of income and the determination of its character is to be made exactly as if the decedent had made the collections. However, the profit included in taxable income is to be treated as an item of income "in respect of the decedent" and a deduction may be taken for the federal estate tax attributable to such income.

Waiving Executors' or Trustees' Commissions

It is frequently advisable for executors or trustees to waive their commissions. The typical case arises when the commissions are payable to persons who are also beneficiaries of the estate. A comparison should be made of (a) the income which these individuals would retain after payment of income taxes if the amounts were distributed as commissions, and (b) the amount they would receive after deduction of the estate tax if the amounts were distributed as a part of the estate. Generally speaking, where the income tax bracket is higher than the estate tax bracket it is desirable to waive the commissions. In making the computations for this comparison, one should look into the possibility of applying Section 1301 which might permit a spreading back of the commission income over a period of years, thus reducing tax brackets.

If the estate will pass to persons related to the executors or trustees but of a younger generation, the consideration of the estate tax liability of the executor's estate may make it advisable to waive the commissions even though the increase in the estate tax as a result of such waiver is greater than the saving in income tax. Assume, for example, that the estate is to go in trust, income to decedent's brother for life, and remainder over to the latter's children. Decedent's brother, who is named as executor, has a substantial estate of his own. If the brother takes his commissions, first there would be payable the income tax and ultimately an estate tax on the balance. The total of such income and estate taxes would generally exceed the reduction in estate tax resulting from the payment of the commissions.

Life Insurance Aspects

By Miriam I. R. Eolis, CPA

Life Insurance as a Valuable Tool in Estate Planning

The following are the factors which make life insurance a valuable tool in good estate planning.

1. Life insurance is one asset which, by proper planning, may either be includible in, or excludible from, the estate.

2. Life insurance can qualify for the marital deduction.

3. Life insurance offers liquidity for payment of estate taxes.

4. Life insurance makes a desirable lifetime gift. It is considered a present interest in property and qualifies for gift exemption and exclusion.

5. As is true of many other assets, there is no income tax on the appreciated value of life insurance during the life of the insured.

6. Probate and administration expenses do not apply to life insurance proceeds payable directly to beneficiaries.

7. Last, but not least, it is a certain (albeit expensive) way to build an estate.

Ownership of Policies

Is it more desirable to have life insurance policies owned by the insured or by beneficiaries? The answer to this question rests principally with the intent of the insured. If it is desired to keep the insurance out of the estate for estate tax purposes, then the policies should be owned by the beneficiaries. To keep the proceeds out of the taxable estate of the insured, he should have none of the incidents of ownership of the policies. The following precautions should be observed.

1. Only the beneficiary should have the right to borrow against the policy or cancel it.

2. The insured should not have the right to change the beneficiary or to change the proportions among a group of beneficiaries.

3. There should be no revesting in the insured in the event the beneficiary predeceases the insured.

4. There should be no reversionary interest in the insured which at the date of death could have a present value exceeding 5 per cent.

5. Under the 1954 Code, payment of premiums by the insured does not make the proceeds part of his taxable estate. Under prior law the opposite was true. There is talk of reinstating the old rule. How such reinstatement would affect situations where premiums are continued to be paid by the insured is an open question.

If life insurance is payable to the estate to provide for liquidity, it enlarges the estate further, and thus, by its own existence, increases the estate tax and the need for cash. To avoid the increase in tax, the insurance may be owned by and payable to the beneficiaries, and the testator's will may give the beneficiaries the option to purchase

Miriam I. R. Eolis, CPA, *formerly chairman of our Society's Committee on New York State Taxation and member of the Committee on Federal Taxation, is currently serving on the Committee on Estate Planning. Mrs. Eolis is a partner in the firm of A. L. Eolis & Associates, Certified Public Accountants.*

assets from the estate to make cash available for payment of estate taxes.

Coordination with Buy-Sell Agreements

Insurance cannot usually be safely coordinated with buy-sell agreements without hazarding possible tax controversy to closely held corporations and their stockholders. It would be preferable, within the bounds of workable business policy, to keep agreements and payout insurance arrangements as separate from each other as is possible.

Deferred Compensation and Qualified Pension Plans

In the case of a deferred compensation plan, which does not fall into the classification of a qualified pension plan, the value of the remainder of the contract is taxable in the estate of the deceased employee. Where, however, the rights of beneficiaries stem from the deceased employee's participation in a qualified pension plan to which contributions were made by the employer, such rights are not includible in the decedent employee's taxable estate except to the extent, if any, that contributions to the plan were also made by the employee. If the pension plan is not a qualified one, the entire amount due to the estate or beneficiaries is includible in the taxable estate of the decedent employee.

Insurance Proceeds Payable to Corporation

Where the insurance proceeds are payable to the corporation which owns the policy, there is the danger that in determining the value of the decedent stockholder's stock for estate tax purposes, the insurance proceeds will be considered an additional asset of the corporation. The argument may well be made that in a closely held corporation, the insurance is maintained to compensate somewhat for the decline in effective management, resulting from the decease of an officer-stockholder. The weight of such an argument will depend largely on the facts and circumstances of the particular case.

Life Insurance and the Marital Deduction

When life insurance qualifies for the marital deduction, how can the proceeds under income options be arranged to minimize tax in the insured's and surviving spouse's estate? One method of minimizing both income and estate taxes is for the husband to take out a life insurance policy which, upon his death, will be payable to his wife for a number of years *certain*, and to her estate or appointees if she fails to live the years *certain*. The value of the policy will qualify for the marital deduction in the husband's estate. The widow will receive the interest element of the annual payment up to $1,000 a year free of income tax.

Life Insurance Proceeds and Ordinary Income

Ordinary income resulting from surrender of a policy before maturity is measured by the difference between the cash received and the premiums paid. Such income, however, may be reported on a three-year spreadback basis. If a policy is assigned before maturity to a beneficiary or to a third party for a valid consideration, the gain computed as above, should qualify as a capital gain. The Service is disputing this in cases where the assignment was made shortly before the maturity of the policy.

Two recent decisions, one by the Tax Court and the other by the Court of Claims should be noted. In the case of *Percy W. Phillips et al.* (30 T.C. No. 87) it was held that the gain on the sale of an endowment policy shortly before maturity was a capital gain since elements besides interest produced the profit. In the case of *Estate of Elsa Wineman* (Ct. Clms. July 16, 1958) it was held that the sale of a deferred

income annuity contract shortly before maturity produced ordinary income rather than capital gain since the profit resulted entirely from the interest element.

Payments by Employers

Payments of $5,000 or less made by employers to an employee's estate or beneficiaries, whether made voluntarily or pursuant to contract, are not subject to income tax as to the recipient. Payments in excess of $5,000, made pursuant to contract, are clearly subject to income tax as to the recipient. There has been considerable litigation under the Code as it existed prior to the 1954 amendments regarding the nontaxability as gifts of voluntary payments. The taxpayers were generally successful. The Service has not yet accepted these decisions. The situation under the 1954 Code has not yet been litigated.

As to the decedent employee's estate, voluntary payments by employers are not considered part of the employee's estate for estate tax purposes. In the case of the employer, voluntary payments have been ruled to be deductible by him if they are reasonable in both time and amount. Payments of two years' salary have been held to be reasonable, and therefore deductible by the employer.

Surrender of Policy Prior to Maturity

Surrender of a policy before maturity results in ordinary income for the owner. However, where the policy held is an endowment policy, it is possible that by selling the policy shortly before maturity (for slightly less than full value) the profit may be a long-term capital gain. As previously noted, this treatment is now being contested by the Service.

The insured can defer the realization of income by electing certain options under the endowment contract whereby the receipt of the proceeds is deferred.

Charitable Foundations, Marital Deductions and Other Phases

By Morton Geller, CPA

Exercising Control by Power of Appointment

The Revenue Act of 1948 stimulated the use of the power of appointment in testamentary trusts so as to qualify the trust for the marital deduction. In order for the decedent's estate to obtain the marital deduction, it is essential that the surviving spouse receive the property outright, or if it is held in trust for the spouse that he or she be given a general power of appointment. The testator may specify the conditions concerning the exercise of the power. To decrease the possibility of an unwise exercise of the power in favor of a second husband to the detriment of testator's children or other relatives,

the will may require that the spouse exercise the power during her lifetime (rather than by her will) and that the instrument evidencing such exercise of the power be presented in person to the fiduciaries of the trust. Presumably, this would give the trustees an opportunity to speak with her concerning the exercise of the power and perhaps, since the exercise during lifetime is ineffective until her death, she may be dissuaded from an unwise act.

Redemption of Stock

Assume that upon the audit of an estate tax return a substantial increase in the valuation of stock is proposed by the Commissioner. On the basis of the valuation originally determined, the stock did not qualify for capital gain redemption. If the commissioner prevails, the stocks would qualify. Is it too late to effect a redemption at favorable capital gains rates or even at no gain?

It is not too late to effect a redemption at favorable capital gains rates or even at no gain. Section 303 of the Code permits the closely held corporation to purchase as much of the stock held by an estate as is necessary to pay all death taxes and interest thereon as well as funeral and administration expenses. To the extent that the proceeds do not exceed such taxes and expenses, they are treated as a distribution in full payment in exchange for the stock so redeemed. The basis for determining gain or loss is the valuation in the decedent's estate. Therefore, it is quite possible for the stock to be redeemed without income tax if the stock is purchased at the same price as valued in the decedent's estate. If the proceeds received exceed the sum required for taxes and other estate expenses, the excess might be treated as ordinary dividend income.

MORTON GELLER, CPA, *is a partner in the firm of Geller and Geller, Certified Public Accountants. He is currently serving as a member of the Society's as well as of the American Institute's Committees on Estate Planning. Mr. Geller is a lecturer on taxation at the Baruch School of Business and Public Administration, The City College of New York.*

It should be noted that this treatment of distributions in redemption shall apply only to amounts distributed after the death of the decedent and within the usual three-year period of limitations or within 90 days after the expiration of the statutory period, or, if a petition has been filed with the Tax Court, at any time before the expiration of 60 days after the Tax Court decision becomes final.

Sometimes advance planning may insure the benefits of this Section. For example, if the estimated value of the stock is only 30 per cent of the expected gross estate and only 40 per cent of the expected taxable estate, it may be possible to make lifetime gifts of other estate assets so that the stock will be more than 35 per cent of the gross estate or more than 50 per cent of the taxable estate. It may also be possible to increase the value of the corporate stock by having the corporation buy life insurance on the life of the stockholder, or through the conversion of debt owing to the stockholder into capital stock.

The "Sprinkling Trust"

A husband in his will sets up a testamentary trust. The income of the trust is payable to his wife and to each of four children in such amounts as an independent trustee, such as a bank, may determine. Can the trustee use such a discretionary power to allocate

the amount of income upon which the wife and children will be taxed?

A bank functioning as an independent trustee may use discretionary power to allocate the amount of income between the wife and children or, if the power clause and local law permits, to retain part of the income for future distribution. Where the trustee has such power the trust is known as a "sprinkling trust."

If the trustee is not related to the grantor or a "subordinate party" and all income must be distributed to one or another of the beneficiaries, none of the income will be taxable to the grantor or the trustee. No standard or limitation need be set forth and the greatest flexibility is possible. It is also permissible to name a member of the grantor's family as co-trustee with an independent trustee and achieve the same flexibility.

Where it is essential that related persons solely be trustees, the power to "sprinkle" income or corpus should be "limited by a reasonably definite standard which is set forth in the trust instrument" in order to avoid taxation to the grantor. Even if a definite standard is set forth, where there is a power to "sprinkle" corpus, the grantor should not be a trustee unless at least half of the trustees are independent.

Conflict of Interests and Tax Savings

A conflict of interests can arise between various beneficiaries—for example, life beneficiaries and remaindermen. What can be done to permit the filing of a joint return for the final income tax return of the decedent? Or, for consenting to split of gift between spouses where a gift was made by the decedent or spouse? Or, for valuing property at a higher value one year from death which of course would result in higher estate tax but possibly save future income taxes?

The fiduciary is often faced with the problem of making tax decisions which may adversely affect one or more beneficiaries. There are, it would seem, three basic questions to be answered in seeking a solution:

1. Which election will result in the greatest over-all tax savings for the decedent's heirs?

2. Has the executor the authority (under the instrument under which he acts, under local law, or under the Code) to exercise his choice freely, if it may be detrimental to any of the beneficiaries?

3. Must the fiduciary make whole the beneficiary who has been adversely affected by the election?

It would be desirable that the instrument give the fiduciary the authority to exercise his discretion in making elections. There is some question as to whether it is wise or sound that the fiduciary's election be determinative of the property rights of all beneficiaries, so that the heirs shall be bound, without recourse, by whatever decision a fiduciary makes, particularly where it may favor one heir at the expense of another or even result in an over-all loss to the estate. It would also be helpful if the instrument were to give specific guidance on the various elections indicating the intention of the grantor or testator.

There have been a number of State court decisions dealing with particular phases holding that the injured beneficiary must be made whole by the beneficiary who has benefited from the election. It would seem that as a practical matter, until this issue is further clarified by judicial opinions, the fiduciary should consult all the interested parties, providing they are competent, before exercising his election. It would be wise, after reviewing the various alternatives, to obtain agreement upon

the course of action and the respective claims of the various beneficiaries. The following are some specific suggestions:

1. If a gift is made and it is desired that it be taxed as if made one-half by each spouse, the spouse making the gift should obtain, at the time of making the gift, the consent of the other spouse to having the gift so treated.

2. If there is any possibility that following the death of one spouse, either the executor of the deceased spouse or the surviving spouse would refuse to agree to the filing of a joint return, an agreement should be entered into providing that a joint return be filed if the filing of a joint return with the survivor would produce a lessor tax than the aggregate tax on separate returns. Such agreement should provide for the allocation of any payments made on joint declarations of estimated tax liability and for the allocation of the tax on the joint return. In the absence of such agreement, the will should give the executors authority to file such joint income tax return and to consent to the division of the gifts prior to death of the other spouse.

The Marital Deduction

In general, there are three ways of stating the marital deduction bequest:

1. As a dollar amount.

2. As an "amount equal to one-half of my adjusted gross estate, etc."

3. As "such fractional part of the residues of my estate as will equal the maximum marital deduction, etc."

Each of these methods has its advantages and disadvantages. The first two methods create a "pecuniary" legacy. And, if the legacy is satisfied with securities which have a value at the time of distribution in excess of their value for estate tax purposes, the estate will have taxable gain on the distribution. They also have the disadvantage that due to increases or decreases in value during the period of administration, the marital deduction bequest may be a greater or lesser portion of the net distributable estate than the testator had intended. The third method has the disadvantage that, again due to changes in value during administration, the *value* of the marital deduction bequest may be greater or less than intended by the testator, and thus upset the tax planning of the estates of the two spouses.

On balance, the "fractional part of the residual estate" method is preferable, coupled with a further provision that valuation in the final federal estate tax proceedings should control the determination of the fractional share. This is a problem with which attorneys have been struggling since 1948, when the provision for the marital deduction was added to the estate tax law. Apparently, no completely satisfactory solution, applicable generally, has been evolved.

Even though a comparison of the aggregate estate tax on the estates of both spouses with and without the marital deduction shows that the use of the marital deduction will increase the aggregate tax, there are other factors which may make it advisable to use the deduction. If the deduction is used, less money will be needed for estate tax in the first estate, thus increasing the fund to be invested to produce income for the surviving spouse. Furthermore, the surviving spouse may invade capital or make lifetime gifts which will reduce the tax payable on the second estate.

The laws of most states contain a presumption as to which of two spouses, who died in a common accident, will be deemed to have been the first to die where the actual order of death is not

known. If the application of such presumption would increase the aggregate tax of the two estates, or result in a distribution of the estates contrary to the intent of the testators, their wills should contain a "common disaster" clause which states the presumption as to the order of death which should govern their two estates. To illustrate, husband and wife have approximately equal estates. Their wills provide for marital deduction, even though such provision will increase the aggregate estate tax liability of the two estates. The state law presumes that in a common accident the wife died first. The husband's will needs no "common disaster" clause, since the presumption makes the marital deduction bequest in his will inoperative. But the wife's will should provide that in a common disaster, her husband should be deemed to have died first, thus making her marital deduction bequest inoperative. Without such a clause, the marital deduction bequest would have decreased her taxable estate and increased that of her husband, with a consequent increase in estate tax.

The Charitable Foundation

Contributions to a foundation, organized in the United States, its territories or possessions and operated exclusively for religious, charitable, scientific, literary or educational purposes, are deductible for income, estate and gift tax purposes. The foundation itself will be exempt from income tax.

It may be desirable to create a foundation during life although it does not operate until death. One method is to establish a trust reserving income for life and giving the remainder to charity. There is no gift tax because the only gift is of a charitable remainder. This method also permits low basis assets to be sold by the trust without capital gains, since capital gains are permanently set aside for charity. Although the trust will be included in the creator's gross estate because of the reserved income, it will not increase the taxable estate because of the gift to charity. In fact, the inclusion of the trust in the gross estate is a possible estate tax saving since the marital deduction is also increased.

Establishment of the foundation prior to death will permit its approval by the Internal Revenue Service during the lifetime of the creator. If necessary, modifications to conform with Treasury Department rules may be readily adopted.

It may be used during lifetime to effect income savings, as a receptacle for art collections, real estate or other non-liquid assets. In order not to exceed the 20 per cent or 30 per cent income tax charitable deduction limitations, undivided remainder interests may be given over a period of years. Further, it is possible to give low basis, closely held stock to foundations and the resulting income tax savings may assist in providing liquidity at death.

Stocks in Canadian Corporations

Stocks in Canadian corporation owned by citizens of the United States are subject to Canadian estate tax and the Canadian proceedings necessary to permit transfer of such stocks are time consuming. To permit immediate disposition of such securities by an executor they should be held in "street names."

The Accounting Division of the Federal Trade Commission

By ARTHUR E. LUNDVALL, CPA

This article describes the nature and functions of the Accounting Division, a unit of the Federal Trade Commission's Bureau of Investigation. In addition to the undertaking of analyses and studies of pricing policies and cost data on Robinson-Patman cases, the Commission's accountants participate in substantially all of its major economic and general investigations having accounting significance.

The Accounting Division of the Federal Trade Commission is a service organization and, upon request, furnishes accounting services in connection with the investigation and trial of legal cases and in general economic investigations.* It is a unit of the Commission's Bureau of Investigation and consists of a staff of 16 people. It supplies accounting services principally to the Bureau of Investigation, but it also furnishes the services of accountants to the Bureau of Litigation, the Bureau of Consultation, the Compliance Division of the General Counsel's Office, and the Bureau of Economics. At times it also furnishes accounting services to other government agencies and to Congressional committees.

During the past fiscal year, accounting services were furnished in connection with 69 legal cases and investigations. These included 31 Robinson-Patman cases, 12 other Clayton Act cases, and 26 cases relating to Section (5) of the Federal Trade Commission Act. Accounting services were also furnished in connection with the Commission's economic and statistical studies.

Robinson-Patman Cases

The accounting work on Robinson-Patman cases consists of (1) analysis and studies of the pricing policies of respondents or proposed respondents to determine the extent of price differences, and (2) evaluation of cost data submitted by respondents in justification of price differences.

The accounting studies of pricing policies to determine the extent of price differences are requested by project attorneys and trial attorneys and involve

* The views expressed herein are those of the author and not necessarily those of the Federal Trade Commission.

ARTHUR E. LUNDVALL, CPA, *is Chief Accountant of the Federal Trade Commission's Division of Accounting, Bureau of Investigation.*

This article has been adapted from a paper presented by the author at a technical meeting sponsored by our Society's Committee on Cost Accounting and Inventory Methods.

comparisons of prices charged by sellers for products of like grade and quality sold in competition in interstate commerce during a given period of time. Statistical tabulations of these comparisons are prepared by the Commission's accountants to point up the evidence and assist in the trial or other disposition of a case. The information is obtained from price lists, invoices, sales contracts, credit memoranda or any other sales records evidencing discounts, allowances, annual volume rebates or other price concessions resulting in price differences.

Such records are ordinarily obtained by the attorney examiner, and in some instances by the Commission's accountants when the magnitude and complexity of an investigation justify the use of accountants in the field to analyze, interpret and tabulate the price data from the books and records of the companies involved.

Section 2a of the Robinson-Patman Act contains the cost proviso and states, "that nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered."

In an effort to justify such price differences, a respondent may elect to present an analysis of his cost of doing business with different customers or classes of customers. When a cost justification is submitted in defense of price discrimination, the burden falls on the respondent to prove that his price differences make no more than due allowance for differences in cost of manufacture, sale or delivery resulting from the differing methods or quantities in which goods of like grade or quality are sold and delivered.

Distribution Costs

Accounting under the Robinson-Patman Act is concerned primarily with costs of distribution. Savings in manufacturing costs are not often advanced in justification of price differences because the greater portion of goods sold is manufactured for stock to meet the needs of all customers and is not manufactured on special order or specification to meet the needs of certain customers. However, in some cases respondents claimed savings in manufacturing costs for this reason. For example, the companies involved in the U. S. Rubber Footwear and B. F. Goodrich Footwear cases manufactured private brand merchandise for certain chain and mail order houses which differed in certain respects from footwear manufactured and sold under their own brand names for their regular customers. Cost savings resulted from fewer styles and varieties and larger production runs for the private brand footwear compared with the regular company brands.

Accounting for distribution costs is more complex than accounting for manufacturing costs—which is pretty well established. Distribution costs include the costs of direct selling, sales promotion and advertising, warehousing, shipping, transportation and delivery, order handling, billing, credit and collection and all supervisory and other activities relating to the sale of goods of like grade and quality. As between customers, these costs per dollar of sales vary with the commodities handled, the territories in which the goods are sold, the quantities in which sold, the channels through which sold, and the methods of sale and delivery.

For the most part, distribution costs are not readily ascertainable from the formal books of account. Analyses are required not only of these records but also of such collateral statistical records

as those which record the activities of salesmen and the functions of order handling and billing, in order to determine distribution costs applicable to products and classes of customers as a means of justifying pricing policies. It is the experience of the Commission's accountants that most companies do not make such analyses, with the result that the companies have no information concerning whether or not they can cost-justify their pricing policies under the provisions of the Robinson-Patman Act. It is only when faced with a problem of cost justification that any systematic analysis of costs is undertaken.

Variations Between Companies

To some extent the distribution activities of every company differ from those of every other company. Some companies sell to wholesalers, some directly to retailers, and some to a combination of both. Also, the price structures and the commodities manufactured and sold vary as between companies, not only in different industries but in the same industry. The terms of sale may differ because of variation in discounts based on quantity or volume, or because of variation in treatment of transportation and delivery charges.

Variations between companies in methods of distribution, in terms of sale and in commodities sold create problems of cost accounting which can only be solved in the particular circumstances of a given case. The method of allocating joint costs and other cost finding techniques to be employed will vary as conditions vary from case to case. The principles to be employed are those that are most logical under the circumstances and bear a direct relationship to the functions that give rise to the expense. This may be illustrated by salesmen's salaries and expenses, one of the largest single items of distribution costs.

Salesmen's salaries and expenses might be allocated to customer price-brackets by a method which is logical under one set of circumstances but might not be logical under other circumstances. For example, where salesmen's calls on customers are relatively routine, and there is no reason to believe that on the average they should spend any more time with a customer in a given price-bracket than with one in any other price-bracket, the allocation of salesmen's salaries and expenses at so much per customer-call may be logical. On the other hand, this method of allocation may not be satisfactory where the nature of the business is such that there is a disparity in the time of the salesmen's calls on customers in the different price-brackets. Under these circumstances an allocation of the salesmen's salaries and expenses on the basis of time spent with the customer may be required. This would be a more difficult method of allocation in that it would require a study for a representative period of time spent by salesmen on their calls on customers.

Analysis of Respondents' Cost Data

Where costs are offered as a defense it is the function of the Commission's accountants to make a careful study of the respondent's cost data to determine whether it is adequate as a justification for its price differentials and conforms to the provisions of the Robinson-Patman Act. This often requires visits to the respondent's place of business by the Commission's accountants to study at first hand its price policy, methods of distribution and the basic records and procedures used in preparing the cost defense. This often requires extensive accounting and statistical analysis of the respondent's costs and operating data, and the preparation of memoranda and report.

After complaint has been issued, the Commission's accountant making the study of the respondent's cost report confers with the trial attorney concerning the presentation of the accounting data at hearings before a trial examiner, and, as required, may appear as a witness for the Commission.

Studies in Distribution Cost Accounting

Recognizing the difficulties involved in the preparation of a cost defense by a respondent, the Commission, early in its administration of the Robinson-Patman Act, undertook to make a survey of what had been done in the field of distribution cost accounting, with a view to formulating a guide to business enterprises desiring to comply with the statute and to the Commission in its administration of the Act.

A comprehensive study was made of two sources of case material: business firms, and the files of the Commission which had been accumulated in the administration of the Robinson-Patman Act. A report of the results, entitled "Case Studies in Distribution Cost Accounting for Manufacturing and Wholesaling," was published by the Commission in 1941.

Another study of this subject as a guide to business was made by an advisory committee appointed by former Chairman Howrey of the Federal Trade Commission in November, 1953. He stated that the purpose of the committee was to determine whether standards of proof and procedures for costing could be developed which could be adopted by the Commission as guides to business. The results of this study appear in a report entitled, "Advisory Committee on Cost Justification Report to the Federal Trade Commission."

Other Accounting Functions

The accounting work on other Clayton Act cases involves primarily those under Section (7) of the Act which deals with acquisitions and mergers. Upon public announcement of an acquisition or merger, an examination is made by the Accounting Division of financial and trade journals and other sources of information to determine as quickly as possible the essential facts concerning the operations of the companies involved that will enable the legal staff to evaluate the significance of the merger. The desired information includes the industry in which the companies are located, their rank as to size, the products or services in which engaged, number of employees, amount of assets, sales and profits of the last calendar or fiscal year, description of property acquired by the acquiring company and the nature and amount of consideration paid.

Other work by the Accounting Division during the investigation of a merger consists of analyses of operating results and financial position of companies before and after mergers, to determine to what extent, if any, declining earnings or a weak financial structure may have influenced the merger. Also, in some cases, statistics are compiled concerning production, shipments and interplant transfers of the products of the acquiring and acquired companies for the purpose of determining their market position with respect to the products of the industry in which they are included.

The accounting assistance furnished in cases arising under Section (5) of the Federal Trade Commission Act consists in part of a study of the pricing policies of respondents or proposed respondents to determine the extent of price uniformity among sellers. Analyses are made of price lists, invoices, sales contracts, and other pertinent records as a basis for comparisons of the prices charged by respondents for their respective products in the different zones or geographical areas in which sold.

Other accounting work on Section (5) FTC cases consists of the analyses and preparation of cost accounting data from books of account and other records of respondents to determine the extent, if any, of alleged sales below cost.

In addition to the accounting work on legal cases, the Division performs work in connection with other aspects of the Commission's functions. For example, during the last fiscal year it prepared a report on rates of return for identical companies which comprised in 1940 the major part of each of 25 manufacturing industries, and for the 12 largest companies in each of 39 industries for the years 1954 and 1955.

Accounting has always played an important part in the Commission's work. The Commission's accountants have participated in nearly all of the Commission's major economic and general investigations with respect to the accounting aspects of the inquiries.

From time to time the services of the Commission's accountants are also utilized in connection with inquiries by Congressional committees. For example, in the current inquiries being conducted by the Subcommittee on Antitrust and Monopoly Legislation, Senate Committee on the Judiciary, the Commission was requested to furnish the Committee with information concerning the long-term profits of companies in a number of industries.

Competence and Integrity

Nothing can possibly be of more importance to a profession, therefore, than the standards of competence and integrity of the individuals of which it is composed. What are we doing to ensure that those standards are kept at the highest possible levels? What should we be planning to do in the future? These are fundamental questions that we must constantly ask ourselves and to them we must give honest, well reasoned answers enabling us to steer a true course and to avoid the many hazards that lie ahead. Selection and education of those entering the profession and the education of those already in the profession are, of course, the key factors. Much has been done and is being done. Uniform examinations and marking, leadership given by the research committee, attention devoted to professional conduct are a few examples. All have helped the chartered accountant to meet competently and efficiently the demands of business large and small; all have contributed to his present standing in the community.

EDITORIAL, "Growing Up—Not Growing Old," THE CANADIAN CHARTERED ACCOUNTANT, June 1958

The Allocation Formula for New York City Gross Receipts Tax

By Louis Goodgold, CPA

This article discusses the technicalities involved in the application of the formula for allocating receipts from sales in interstate commerce, which was last promulgated on March 4, 1955. The revised formula is the result of the decision in the case of *Matter of Gulf Oil Co.* v. *Joseph* which invalidated the formula previously in effect.

Before discussing New York City's present formula for allocating and taxing receipts from sales in interstate commerce, I believe it is pertinent first to consider the following topics: the sections of the local law authorizing the City to impose the tax; the limitations in the law and the restrictions imposed by the constitution of the United States against the City's power to impose the tax; some of the court decisions setting forth the conditions under which the City may impose the tax; a brief discussion of the old allocation formula; the reasons for invalidating the formula; and the definitions of the various types of receipts used in the present formula.

Louis Goodgold, CPA *and member of the New York Bar, is Chief of the Bureau of Excise Taxes of the Office of the Comptroller of the City of New York. He is the author of the Rules and Regulations pertaining to the New York City Sales and Business Taxes, and of numerous articles on local excise taxes.*

This article has been adapted by the author from a paper presented by him at the 1958 technical meeting sponsored by our Society's Committee on Municipal and Local Taxation.

Relevant Provisions of the Law

Under the law (Section B46-2(a) of the Administrative Code of the City of New York), a tax is imposed upon every person for the privilege of carrying on or exercising for gain or profit within the City any trade, profession, vocation or commercial activity, or of making sales within such city for each of the periods of one year or any part thereof, commencing with July 1, 1955, and for each year thereafter, commencing July 1st. The excise tax must be paid upon all receipts or gross income, as the case may be, received in and/or allocable to the City from such profession, vocation, trade, business or commercial activity exercised or carried on by such person during the calendar year in which each said period of one year shall commence.

Under Subdivision (b) of Section B46-2, it is provided that,

where a receipt in its entirety cannot be subjected to the tax imposed by reason of the provisions of the Constitution of the United States or any other provision of law, the Comptroller shall establish rules and regulations and/or methods of allocation and evaluation to the end that only that part of such receipt which is properly attributable and allocable to doing business in the City shall be taxed hereunder. The Comptroller may make such allocation with due regard to the nature of the business concerned on the basis of mileage, division of the receipt according to the number of jurisdictions in which it may be taxed, the ratio of the value of the property or assets of the taxpayer owned or situated in the City to the total property or assets of the taxpayer wherever owned or situated and/or any other method or methods of allocation other than the foregoing calculated to effect a fair and proper allocation in accordance with the purposes of this subdivision.

Constitutional Restrictions

Under the constitution of the United States (Article 1, Section 10, Clause 2), the City is without power to impose a tax upon receipts in foreign commerce. The City is also without power to impose a tax upon receipts from transactions which originate and terminate outside the territorial limits of the City. Such receipts, under the regulations, are defined as non-allocable and non-taxable receipts. There is nothing in the constitution of the United States which prohibits the City from imposing a tax on receipts in interstate commerce on an allocated basis. Article 1, Section 8, Clause 3 of the Constitution, dealing with commerce among the states, merely provides that, "Congress shall have the power to regulate commerce among the several states . . . ." Accordingly, receipts in interstate commerce may be the subject of allocation.

Significant Court Decisions

I shall not go into a detailed discussion of the cases involving the question of when the City may impose a tax on interstate commerce receipts on an allocated basis. Suffice it to say that, where the receipts from activities engaged in by a corporation within the City are exclusively interstate, no tax may be imposed by the City upon such receipts. The mere fact that local activities occur in the City obviously in and of itself is not enough to empower the City to impose the tax on interstate receipts since, in practically every case of sales across state lines, there are local activities in the state of origin and the state of destination.

To determine where the line should be drawn, consideration must be given to the nature of the interstate commerce and the nature of the local activities. Basically, the question necessarily must be whether the local activity is so essential an element of the interstate commerce as to be an integral part of it. Where a local activity is deemed to be an integral part of the interstate commerce, the tax on the commerce will not be sustained. Where the local activity is not such an integral part of the interstate commerce, a state tax, or city tax in this case, imposed on such local activity will be sustained and, since such local activity, because of the use of the same factors, helps to increase the interstate commerce, a tax on such interstate commerce on an allocated basis will also be sustained. The cases which have been recently decided and bear out this statement are *United Air Lines* v. *Joseph* (282 App. Div. 4, Aff'd. 357, N.Y. 762); *National Steel Corp.* v. *City of New York* (283 App. Div. 867, 1st Dept.); *United Piece Dye Works* v. *Joseph* (307 N.Y. 780); and *Field Enterprises Inc.* v. *State of Washington* (352 U.S. 806; 1956).

The Old Allocation Formula

A formula providing for the imposition of the tax on interstate commerce

receipts on an allocated basis, while it need not be mathematically exact, must be reasonable and not arbitrary. If it is unreasonable or arbitrary, the courts will reject it and declare it invalid (*Matter of Gulf Oil Co.* v. *Joseph*, 283 A.D. 309, Aff'd. 307 N.Y. 342). Until the decision was handed down by the courts in the *Gulf Oil* case, the City's allocation formula under Article 211 of the Business Tax Regulations with respect to receipts from sales in interstate commerce, was based on three factors, viz., property, wages and receipts. The formula was as follows:

$$\frac{\text{Real and Tangible Personal Property within N. Y.C.}}{\text{Real and Tangible Personal Property within the U. S.}} = \%$$

$$\frac{\text{Wages, Salaries and Other Personal Service Compensation in N. Y. C.}}{\text{Wages, Salaries and Other Personal Service Compensation in the U.S.}} = \%$$

$$\frac{\text{Wholly Taxable Receipts} + \tfrac{1}{3}\text{ of Allocable Receipts}}{\text{Wholly Taxable Receipts} + \text{Allocable Receipts}} = \%$$

$$\text{Total} \quad \%$$

The total of the three resulting percentages was then averaged. If the average percentage exceeded 66⅔%, it was reduced to 66⅔%. If the average percentage was less than 33⅓%, it was increased to 33⅓%. This average percentage was then applied to the allocable receipts to determine the amount thereof subject to tax.

An alternative formula for use by New York City manufacturers was also provided, but will not be discussed at this time, since it has not been changed.

Development of the New Formula

In the *Gulf Oil* case, the average percentage of the three factors, based on the then existing allocation formula, was approximately 31½% or 32%. The City, however, upon audit, and in accordance with the formula, increased the average percentage to 33⅓%. Because of this 33⅓% floor, the court declared the formula to be arbitrary and therefore invalid, and remanded the case for a new formula. It must be pointed out that the court's action in invalidating the formula did not invalidate the tax law nor destroy the right to tax at all. Accordingly, the Comptroller proceeded with the promulgation of a new formula.

Before promulgating the existing formula, the Bureau considered the promulgation of a number of other formulas. However, in practically every case, the factors used and their methods of application were weighted heavily either in favor of the City or the taxpayer and therefore were abandoned. In promulgating an allocation formula, consideration must be given to its simplicity, its reasonableness, its effect on local business, and its effect on revenues.

It is believed that once the principles upon which the new formula is based are understood, it will be admitted that it is very simple. The formula is also reasonable because it gives effect to all of the factors which contribute to the production of receipts from both local and interstate activity. Furthermore, it eliminates all minimum percentages or floors, and therefore cannot be said to be arbitrary, and retains the ceiling of 66⅔% which was in the old formula, thereby benefiting those businesses in the City which otherwise would be required to pay the tax on a higher percentage basis. Finally, it must be admitted that under the new formula some taxpayers will pay a greater tax on interstate commerce receipts, while others will pay a smaller tax, with the result that the total revenues realizable will be neither more nor less than under the old formula.

In order to more fully understand the allocation formula, it is necessary that we comprehend what is meant by wholly taxable receipts, non-taxable receipts and non-allocable receipts, and allocable receipts. In the course of this article, I shall use the terms allocable and interstate commerce receipts interchangeably.

Wholly Taxable Receipts

Wholly taxable receipts include the following:

1. Receipts from sales where the shipment of the property is made from the vendor's source of supply in New York City and delivered to a customer in New York City or New York State, or to a third party located outside the City or State of New York designated by the New York City customer;

2. Receipts from sales where the shipment of the property is made from the New York City vendor's own source of supply outside of New York City, but within New York State, and delivered to a customer in New York City; and

3. Receipts from sales where the vendor in New York City causes delivery of the property to be made to a customer in New York City from a third party's source of supply outside the City or State of New York.

Non-Taxable and Non-Allocable Receipts

Non-taxable receipts are those receipts which are not subject to tax by reason of constitutional prohibition. These include receipts from sales of exports and receipts from sales by the importer of imports in the original unbroken package.

Non-allocable receipts include receipts from sales where the merchandise is shipped from the vendor's premises or an independent source of supply, located outside the City of New York, and delivered to a customer located outside the City of New York.

Allocable Receipts

Allocable receipts are receipts from (a) sales made by a New York City vendor to purchasers located outside New York State where the goods are shipped from the vendor's source of supply in New York City and delivered directly to the purchaser at a point outside the State of New York, or to a packing company or a common carrier in the City for destination at a point outside New York State; and (b) sales made and delivered to a New York City purchaser from a New York City vendor's premises outside the State of New York.

Factors in the Revised Allocation Formula

The revised allocation formula, which was promulgated on March 4, 1955, is set forth in Bulletin 1955-2 (issued by the New York City Bureau of Excise Taxes of the Office of the Comptroller). This revised formula is presented on page 649.

The general purpose of the formula is to determine the amount of the interstate commerce receipts which may be fairly attributed to business conducted in the City, and so be included in the measure of the tax. The formula recognizes the interrelationship between receipts, property, and wages, and utilizes all three factors, but, in the interest of accuracy, it eliminates from the property and wage factors in and out of the City any portions thereof not properly attributable to the production of interstate commerce receipts.

Thus, only the ratio of that part of the property in the City to the total property everywhere, and the ratio of that part of the wages in the City to total wages everywhere attributable to

The Revised Allocation Formula

PROPERTY FACTOR

$$\frac{\text{Numerator}\left\{\dfrac{\text{Allocable Receipts}}{\text{100\% of Receipts Attributable to N.Y.C. in whole or in part}} \times \text{Property in N.Y.C.}\right\}}{\text{Denominator}\left\{\text{Numerator} + \dfrac{\text{Allocable Receipts}}{\text{100\% of Receipts Attributable to outside N.Y.C. in whole or in part}} \times \text{Property outside N.Y.C.}\right\}} = \frac{\text{Property in N.Y.C. attributable to production of allocable receipts}}{\text{Total Property everywhere attributable to production of allocable receipts}} = \text{Percentage of N.Y.C. Property to Total Property Everywhere}$$

WAGES FACTOR

$$\frac{\text{Numerator}\left\{\dfrac{\text{Allocable Receipts}}{\text{100\% of Receipts Attributable to N.Y.C. in whole or in part}} \times \text{Wages in N.Y.C.}\right\}}{\text{Denominator}\left\{\text{Numerator} + \dfrac{\text{Allocable Receipts}}{\text{100\% of Receipts Attributable to outside N.Y.C. in whole or in part}} \times \text{Wages outside N.Y.C.}\right\}} = \frac{\text{Wages in N.Y.C. attributable to production of allocable receipts}}{\text{Total Wages everywhere attributable to production of allocable receipts}} = \text{Percentage of Wages in N.Y.C. to Total Wages Everywhere}$$

$$2 \overline{)\ \text{Total Percentages}\ }$$
$$\text{Average Percentage}$$

Note: Allocable receipts × average percentage = allocated receipts.
Total receipts subject to tax = allocated receipts plus wholly taxable receipts.

the production of interstate commerce receipts are considered in determining the amount of the interstate commerce receipts subject to tax.

Property and wages in New York City produce wholly taxable receipts, receipts from sales in foreign commerce originating or terminating in New York City, and, together with the property and wages outside the City, produce allocable receipts. These receipts represent 100% of the receipts attributable in whole or in part to New York City property and wages.

Property and wages outside the City of New York produce non-allocable receipts and receipts from sales in foreign commerce originating or terminating outside the City of New York, and, together with the property and wages in New York City, produce allocable receipts. These receipts represent 100% of the receipts attributable in whole or in part to property and wages outside the City of New York.

To determine the ratio or percentage of the property in New York City to total property everywhere attributable to the production of allocable receipts, the formula employs a fraction, the numerator of which is the allocable receipts, divided by 100% of the receipts attributable in whole or in part to the New York City property, multiplied by the amount of property employed in the City. This numerator represents the property in New York City attributable to the production of allocable receipts. The denominator of this fraction must include the resulting numerator, plus the following: allocable receipts divided by 100% of the receipts attributable in whole or in part to the property outside of New York, multiplied by the amount of the property outside the City of New York. This denominator represents the total property everywhere attributable to the production of allocable receipts. The resulting fraction is then expressed as a percentage which represents the ratio of New York City property to total property everywhere attributable to the production of interstate or allocable receipts.

The same procedure is followed with respect to the wages factor except that the wages attributable to New York City are substituted for the property in New York City, and the wages attributable to outside New York City are substituted for the property outside the City. The resulting wages fraction is then expressed as a percentage which represents the ratio of the wages in New York City to total wages everywhere attributable to the production of allocable receipts. The property and wage factors percentages are then averaged, and the average percentage is applied to the allocable receipts to obtain the allocated amount thereof includable in the measure of the tax. If the average percentage is more than 66⅔%, it is reduced to 66⅔%. No floor is provided. In other words, if the average percentage is less than 66⅔%, the actual percentage is used.

Illustrative Problems

This article includes an appendix which presents five problems and the solutions, to further clarify the applications of the formula. I do not believe it is necessary to explain all the five problems. However, we will take problems Nos. 2 and 4. If we understand the solutions to these problems, we will understand the solutions to the remaining problems.

In problem No. 2, there are no non-allocable receipts or foreign commerce receipts. The 100% of the receipts attributable in whole or in part to New York City are $100,000, viz., $40,000 wholly taxable and $60,000 allocable. The 100% of the receipts attributable

in whole or in part to outside New York City are **$60,000**, all allocable.

In problem No. 4, in addition to the wholly taxable and allocable receipts, there are non-allocable receipts and foreign commerce receipts. The 100% of the receipts attributable in whole or in part to New York City are $250,000, viz., wholly taxable $10,000; allocable, $90,000; and foreign commerce receipts $150,000. The 100% of the receipts attributable in whole or in part to outside New York City are $340,000, viz., allocable receipts $90,000, and non-taxable receipts $250,000.

Substituting the factors in problem No. 2 for the formula, the property factor percentage will be $84\frac{1}{2}\%$ and the wages factor percentage will be $70\frac{1}{2}\%$. The average of these percentages is $77\frac{1}{2}\%$. Since the maximum percentage applicable to the interstate commerce receipts is $66\frac{2}{3}\%$, the $77\frac{1}{2}\%$ is reduced to $66\frac{2}{3}\%$ which, when applied to the interstate commerce receipts or allocable receipts, will give allocated receipts of $40,000, to which are added the wholly taxable receipts of $40,000, or a total of $80,000 of taxable receipts includable in the measure of the tax.

Substituting the factors in problem No. 4 for the formula, the property factor percentage will be 6 7/10% and the wages factor, 47 6/10%. The average of these percentages is 27.15% which, when applied to the allocable receipts, will give allocated receipts of $24,435, to which are added the wholly taxable receipts of $10,000, or total taxable receipts of $34,435 includable in the measure of the tax. In this case, although the average percentage is less than $33\frac{1}{3}\%$, the actual percentage of 27.15% is used.

Provision for Different Method of Allocation

The objection to the formula which is often raised is that the greater the amount of non-allocable and non-taxable receipts, the greater will be the amount of allocated receipts includable in the measure of the tax. This is true, but the objection is not well taken for the reason that, in such case, the respective amounts of property and wages outside the city attributable to the production of such non-allocable and non-taxable receipts will be more, and the respective amounts of property and wages outside the city attributable to the production of allocable receipts will be less.

In any event it should be pointed out that if in a particular case the Comptroller shall determine, either upon his own initiative or upon application by the taxpayer, that the formula prescribed works unfairly or inequitably to the taxpayer, he may provide for a different or other method of allocation with due regard to the nature of the business concerned, the number of jurisdictions in which the receipts may be taxed, the ratio of the taxpayer's property or assets owned and situated in the City to the taxpayer's total property or assets whereever owned and situated, or any method or methods of allocation other than the instant formula which will effect a fair and proper apportionment in accordance with the principles of allocation as provided for by the General Business and Financial Tax Law. (See Article 210 of the Regulations.)

Basic Data for Illustrative Problems

	Problem No. 1	Problem No. 2	Problem No. 3	Problem No. 4	Problem No. 5
Property in New York City..........	$ 30,000	$ 90,000	$ 5,000	$ 5,000	$ 5,000
Property outside New York City......	100,000	10,000	95,000	95,000	95,000
Wages in New York City...........	15,000	24,000	12,000	12,000	12,000
Wages outside New York City........	75,000	6,000	18,000	18,000	18,000
Wholly Taxable Receipts	55,000	40,000	10,000	10,000	10,000
Allocable Receipts	180,000	60,000	90,000	90,000	90,000
Non-taxable Receipts	120,000	—	250,000	250,000	250,000
Foreign Commerce Receipts—New York City	—	—	—	150,000	—
Foreign Commerce Receipts—Outside New York City	—	—	—	—	150,000
100% of Receipts Attributable in Whole or in Part to New York City					
Wholly Taxable Receipts	$ 55,000	$ 40,000	$ 10,000	$ 10,000	$ 10,000
Allocable Receipts	180,000	60,000	90,000	90,000	90,000
Foreign Commerce Receipts—N. Y. City	—	—	—	150,000	—
100% Receipts Attributable in Whole or in Part to New York City........	$235,000	$100,000	$100,000	$250,000	$100,000
100% of Receipts Attributable in Whole or in Part to outside New York City					
Allocable Receipts	$180,000	$ 60,000	$ 90,000	$ 90,000	$ 90,000
Non-Taxable Receipts	120,000	—	250,000	250,000	250,000
Foreign Commerce Receipts—outside New York City	—	—	—	—	150,000
100% Receipts Attributable in Whole or in Part to outside New York City	$300,000	$ 60,000	$340,000	$340,000	$490,000

Solution to Problem No. 1

PROPERTY FACTOR

$$\left.\begin{array}{lll} \text{Numerator} = \dfrac{180{,}000}{235{,}000} \times 30{,}000 & = & 22{,}978 \\ \hline \text{Denominator} = 22{,}978 + \left(\dfrac{180{,}000}{300{,}000} \times 100{,}000\right) & = & 82{,}978 \end{array}\right\} = 27.69\ \%$$

WAGES FACTOR

$$\left.\begin{array}{lll} \text{Numerator} = \dfrac{180{,}000}{235{,}000} \times 15{,}000 & = & 11{,}490 \\ \hline \text{Denominator} = 11{,}490 + \left(\dfrac{180{,}000}{300{,}000} \times 75{,}000\right) & = & 56{,}490 \end{array}\right\} = 20.34\ \%$$

Total Percentage	48.03 %
Average Percentage	24.015%
Allocated Receipts ($180,000 × 24.015%)	$43,227.00
Add: Wholly Taxable Receipts	55,000.00
Total Receipts Subject to Tax	$98,227.00

Solution to Problem No. 2

PROPERTY FACTOR

$$\left.\begin{array}{lll} \text{Numerator} = \dfrac{60{,}000}{100{,}000} \times 90{,}000 & = & 54{,}000 \\ \hline \text{Denominator} = 54{,}000 + \left(\dfrac{60{,}000}{60{,}000} \times 10{,}000\right) & = & 64{,}000 \end{array}\right\} = 84.5\%$$

WAGES FACTOR

$$\left.\begin{array}{lll} \text{Numerator} = \dfrac{60{,}000}{100{,}000} \times 24{,}000 & = & 14{,}400 \\ \hline \text{Denominator} = 14{,}400 + \left(\dfrac{60{,}000}{60{,}000} \times 6{,}000\right) & = & 20{,}400 \end{array}\right\} = 70.5\%$$

Total Percentage	155.0%
Average Percentage	77.5%
Allocable Receipts ($60,000 × 66⅔%)	$40,000.00
Add: Wholly Taxable Receipts	40,000.00
Total Receipts Subject to Tax	$80,000.00

Solution to Problem No. 3

PROPERTY FACTOR

$$\left.\begin{array}{lll} \text{Numerator} = \dfrac{90{,}000}{100{,}000} \times 5{,}000 & = & 4{,}500 \\ \hline \text{Denominator} = 4{,}500 + \left(\dfrac{90{,}000}{340{,}000} \times 95{,}000\right) & = & 29{,}647 \end{array}\right\} = 15.180\%$$

WAGES FACTOR

$$\left.\begin{array}{lll} \text{Numerator} = \dfrac{90{,}000}{100{,}000} \times 12{,}000 & = & 10{,}800 \\ \hline \text{Denominator} = 10{,}800 + \left(\dfrac{90{,}000}{340{,}000} \times 18{,}000\right) & = & 15{,}564 \end{array}\right\} = 69.390\%$$

Total Percentage	84.570%
Average Percentage	42.285%
Allocated Receipts (42.285 % × $90,000)	$38,056.50
Add: Wholly Taxable Receipts	10,000.00
Total Receipts Subject to Tax	$48,056.50

Solution to Problem No. 4

PROPERTY FACTOR

$$\left.\begin{array}{lll} \text{Numerator} = \dfrac{90{,}000}{250{,}000} \times 5{,}000 & = & 1{,}800 \\ \hline \text{Denominator} = 1{,}800 + \left(\dfrac{90{,}000}{340{,}000} \times 95{,}000\right) & = & 26{,}947 \end{array}\right\} = 6.70\%$$

WAGES FACTOR

$$\left.\begin{array}{lll} \text{Numerator} = \dfrac{90{,}000}{250{,}000} \times 12{,}000 & = & 4{,}320 \\ \hline \text{Denominator} = 4{,}320 + \left(\dfrac{90{,}000}{340{,}000} \times 18{,}000\right) & = & 9{,}084 \end{array}\right\} = 47.60\%$$

Total Percentage	54.30%
Average Percentage	27.15%
Allocated Receipts (27.15% × $90,000)	$24,435.00
Add: Wholly Taxable Receipts	10,000.00
Total Receipts Subject to Tax	$34,435.00

Solution to Problem No. 5

PROPERTY FACTOR

$$\frac{\text{Numerator} = \frac{90{,}000}{100{,}000} \times 5{,}000 = 4{,}500}{\text{Denominator} = 4{,}500 + \left(\frac{90{,}000}{490{,}000} \times 95{,}000\right) = 21{,}951.50} = 20.5\%$$

WAGES FACTOR

$$\frac{\text{Numerator} = \frac{90{,}000}{100{,}000} \times 12{,}000 = 10{,}800}{\text{Denominator} = 10{,}800 + \left(\frac{90{,}000}{490{,}000} \times 18{,}000\right) = 14{,}106.60} = 76.5\%$$

Total Percentage	97.0%
Average Percentage	48.5%
Allocated Receipts (48.5% × $90,000)	$43,650.00
Add: Wholly Taxable Receipts	10,000.00
Total Receipts Subject to Tax	$53,650.00

Scope of Examination

The CPA determines the scope of the examination necessary to express an unqualified opinion. The client, however, determines whether an examination of such a scope will be permitted. It is the CPA's opinion that must be expressed. He assumes the responsibility and he must be permitted to perform all of the procedures he considers necessary if the objective is an unqualified opinion.

There may be reasons why a client decides not to permit an unrestricted examination. While the CPA abides by his client's decision, he patterns his report accordingly. The significance of this to bankers is that they should read the report to be sure that the opinion expressed is adequate for their purposes. To be sure that an acceptable opinion is obtained, they should, before the work is begun, see that the CPA is authorized by his client to perform an examination of sufficient scope to provide a suitable opinion.

from 40 QUESTIONS AND ANSWERS ABOUT AUDIT REPORTS, AICPA, 1956

How to Evaluate and Improve a Records Management Program

By Ellma Frantz

Periodic appraisal by the qualified CPA firm of its clients' records management program will usually more than justify the cost of such efforts. These appraisals may well start with answers to questions included on an appropriate check list and the development of a records control system designed to overcome weaknesses disclosed by these answers. The program will involve a physical inventory of all records, the identification of vital records, the establishment of records retention periods, and the development of forms control and a records filing system. A records control program must always be implemented by competent records-keeping personnel.

Office managers are usually well aware of the need for records management and recognize that control of records creation, keeping, retention and protection is a necessary aspect of office management. Accounting journals, office magazines, and various business periodicals frequently print articles on the cost of a poor records management program and suggest methods by which conditions may be improved. These articles first began to appear after the Paperwork Management Task Force appointed by the Hoover Commission reported the cost of keeping uncontrolled accumulated paper. Through these media, cost figures, statistics, and percentages are presented to prove the economies gained through paperwork control and protection. These savings are real. They appear in additional space resulting from control of the flow of records from the office to inactive storage, and from storage to destruction, depending on the retention schedules established. They result from a reduced volume of files and from an improved filing system. By employing better trained personnel, time is saved in filing and finding records. Savings in money are apparent by reducing the need for purchases of additional equipment and by the savings inherent in a low-cost records center for housing inactive records.

Ellma Frantz, *a specialist in records management, is a member of the Records Management Association of Southern California and the Special Libraries Association. Currently a member of the Management Advisory Services of Price Waterhouse & Co. in Los Angeles, she was formerly a department head and records manager in the firm's New York office.*

What will be the actual percentage of savings realized by a company? It will depend on the type of business and how long it has been in operation without any form of a records control program. A business that has been functioning for twenty years, for example, without a definite program can expect substantial reductions in office filing space and equipment requirements.

A Check List

Through an audit of the files, management can be apprised of the condition of their records keeping system. To base an evaluation on the speed with which an invoice or cancelled checks can be produced is frequently misleading. It is much better to ask the supervisor to explain the filing system being used, the method of indexing, and the period of time files are retained in cabinets as active material.

To investigate the company's records program the following check list may be helpful.

1. *Files.*

How many cabinets are there?
How many cabinets are legal size?
How many cabinets are letter size?
How old is the material filed in the cabinets?
Are the file drawers overcrowded?
Are the folders labeled adequately and clearly?
Are there sufficient guides in the drawers?

2. *System.*

Is there a centralized filing system?
Is the system the most suitable?
Is the system easy to use and follow?
Is the material well indexed and cross referenced on cards?

3. *Records Retention.*

Is there a definite schedule for the transfer of material to the records center and for the destruction of unnecessary material?
Have definite retention schedules been approved by the company's counsel?
Are retention schedules revised regularly?
Do departments comply with retention schedules?

4. *Records Center.*

Is there a low-cost records center or space in such a center that is established specifically for housing the company's records?
Are these records filed in cardboard boxes and stored on steel shelves?
What is the ratio of cubic feet of storage per square foot of area? (The records center should be planned to obtain a ratio of between four and five cubic feet of storage per square foot of area.)
Are index cards maintained for each record?
Are boxes properly indexed?
Is the service good for obtaining records from the center or for receiving information by telephoning?

5. *Forms Control (Records Creation).*

Are forms indexed by number and function?
Is there a procedure for the creation and use of forms within the company?

6. *Records Protection.*

Has the company established which of its records are vital?
Have provisions been made to protect copies of these records?
Is there a vital-records storage center?

7. *Historical Records.*

Have provisions been made to identify company records containing historical data?
Are policies established to protect these documents?

8. *Personnel Evaluation.*

Is the manager of the records department competent?
Is there demonstrated ability to:
work under pressure?
make decisions?
teach others?
motivate others?
supervise others?
handle correspondence?
take disappointments?
talk clearly and concisely?
read rapidly?
reason?
remember details?
be creative and original?

From answers to this check list, an objective appraisal of the company's

records management program—or the lack of one—may be made. If wastes and inefficiencies are apparent, management should be informed of recommended remedial action.

Procedure for Establishing a Records Management Program

If the need for such a program is indicated and management decides in favor of such action, then it must also pledge its full cooperation and support to the plan for records reorganization. No program can achieve its objectives without understanding and assistance from management. Let it be known throughout the organization that the plan has the support of top-level executives.

The next phase after obtaining management's approval for a records control program is to select the persons responsible for developing this program. This may be handled by company personnel or by consultants by one of the following methods:

1. Appoint someone within the organization as the records administrator since this function will usually require the attention of an individual full time. Should there be a desirable candidate in the organization who is suitable according to the job qualifications shown on the check list but who has not had adequate training, he may attend seminars for this purpose. Many of the colleges and universities offer special courses in records management.

2. Employ someone to become a permanent member of the company's staff to function as a records administrator. Well-qualified managers who might be available are limited but an attractive offer should elicit some responses.

3. Use a consultant. Due to the increase in demand for records control programs, consultants have made special effort to obtain training and in general to become qualified in this area. However, in making a selection, several consultants should be interviewed. Ask them to submit proposals as to the scope of their examination, the time required to complete a management program for the company, and what their fees will be. The consultants should prepare a manual of procedures and train company personnel to assure a continuing effort to maintain the new program.

4. A combination of any one of the above. Consultants are frequently employed on a part-time basis to direct a newly trained member of an organization, to help orient the employee, and to implement the records program. By this means the employee gains confidence and management is reassured of the efficiency of its program.

After a records administrator has been selected by management, it becomes his or her function to implement the following generally accepted records retention procedures:

1. Take a physical inventory of all records.

2. Analyze and evaluate records series or groups in terms of retention periods.

3. Obtain approval for retention schedules from authorities in the company and legal counsel.

4. Transfer inactive records to a suitable records center and destroy useless ones.

5. Maintain retention schedules.

The Inventory

Tedious and laborious as this task is, a physical inventory seems to be the only solution for determining what type of records the company has, what years are involved, what the volume is, and where the records are located. Records are papers, reports, books, photographs, maps, drawings, cards, charts, or any

document or copy thereof. These items may be located in cabinets, closets, cupboards, cardboard boxes, or other type of container with the active and inactive documents often filed together.

To identify the records, it is preferable to begin the inventory taking in the inactive storage areas. However, this procedure has the disadvantage of taking the inventory in the more difficult area first. Before taking the inventory one should obtain a floor plan and decide on the equipment code and inventory forms to be used. Mark the sections on the plan beginning at the left of the entrance of the records area, label the equipment, and start the physical inventory from the bottom drawer or box up. Design the inventory record form to record data which are descriptive of the documents filed.

When the inventory is complete, consolidate the inventory and data alphabetically by department and function. Thus there will be a complete list for each type of record arranged alphabetically under each function.[1]

Evaluating the Inventory for Assigning Retention Periods

In this phase of the program, it is necessary to work closely with the filing department head to determine the frequency of reference to a record of a given series or group and the value of the record to the company. These data establish criteria for keeping records in active files and inactive areas. Published indexes concerning requirements of the federal and state governments[2] are available to serve as general guides for recommending retention periods.

After legal and tax requirements are met the retention schedules are submitted for approval. Usually the retention periods are approved by a committee composed of a representative from the financial, legal, and executive departments of the company. As soon as the retention schedules are approved, the next phase of the program may be started. For examples of forms used by various companies for records retention and control see "Case Studies in Records and Control," prepared for the Controllership Foundation, Inc.[3]

Using and Maintaining Retention Schedules

Retention schedules will establish the flow of those records which may be moved from office to storage to destruction. Schedules will also indicate those records which are historical and vital. Records which must be retained permanently in the office area or records center are so marked. Retention schedules tell management and departmental personnel when, where, and what will happen to each record series.

Due to policy changes, retention schedules may need altering. Keeping abreast with the new records and changes in use of records is an important phase of the work. Constant supervision and maintenance are necessary to assure the success of the records program.

Transferring Records to a Records Center

Before records can be transferred, a low-cost area is needed to house them, i.e., a "records center." This center is used for housing inactive and semiactive records. Equipping the records center has become almost as exacting as establishing periods for retention, though the equipment is fairly well standardized. Steel shelving is generally used, measuring 42 inches wide by 30 inches deep and 123 inches high. A shelving unit has 6 shelves and holds 72 containers arranged three wide, by two deep and two high. These standard-size containers, which service both legal

and letter-size folders, measure 10 inches in height, 12 inches in width, and 15 inches in depth. Two containers will hold the contents of one legal file drawer while three containers can store the contents of two letter-sized drawers.

The use of standard equipment makes possible an orderly arrangement of cartons. This simplifies indexing of records, for the spaces are prenumbered and boxes assigned a number are placed in a definite location.

As records are boxed by series in containers for transfer to the records center—depending, of course, on the retention schedules—a list is prepared in duplicate for the contents of each container. One copy of the list remains in the department. The other copy accompanies the records to the center. Upon receipt of both records and list, the center personnel verify the contents against the list and then stamp the container with a number representing a specific space. This number is also recorded on the list in the records center and is posted to an index card for each records series. This card has the retention schedules, date of records covered, their alphabetical or numerical range, and the box number. Through this system of numbering boxes and maintaining a card index, a control is established which improves the speed with which records are made available for use. As a result of good service, confidence is increased in the records center, and management becomes less reluctant to transfer semi-active records to the low-cost area.

For those companies that have insufficient records to warrant establishing their own records center, commercial records centers specializing in serving several concerns are to be found in many cities. These centers are organized on much the same principle as previously described. They offer similar service in indexing, storing, and destroying records. The service, according to the companies who have used their facilities, is good.

Historical and Vital Records

During the evaluation of the inventory is the time to note those records which may be of historical significance. While a company may have no immediate plans to write its history or have it written, it may wish to do so at some future date, and the historian will be most grateful for the preservation of these documents. The long-range benefit of having these records available when needed offsets the cost of retaining them on a permanent basis. According to the statisticians, less than five per cent of all records are classified as permanent.

Vital records, as the name implies, are essential. They are defined as those documents, records, ledgers, minutes, etc., necessary to the continuing functioning of a business. They are those records which if destroyed would impair if not prevent a business from continuing to operate. To identify these items and to protect a copy of each is one of the most important aspects of a records program. Management itself will have to identify the records to be protected based on its own operations and functions. If a guide is needed for such identification, see Robert A. Shiff's article, "Protect Your Records Against Disaster," in the *Harvard Business Review*.[4]

In this article are listed the accepted methods for protecting records. They are:

1. *Built-in dispersal.* This method consists simply of making sure that duplicate copies of records are kept in two or more separate locations. For example, in a multiplant company, a plant may retain an original record and send a copy to the home office. Also for many kinds of records, banks, insurance companies, and government

agencies (particularly tax agencies) will have duplicates in their files; there is no need to keep further copies so long as management knows that the record is kept at a sufficiently distant location, that it is retained for the necessary length of time, and that adequate safeguards are assured.

2. *Designed copy dispersal.* This method involves evacuation of an existing copy of a vital record from the department preparing or filing the record to a vital records center.

3. *Evacuation or vaulting of the original.* Where records have been designated as vital but are referred to infrequently, the most economical and effective protection method is to send the original to a vital records center. This method eliminates costly reproduction and maintenance of duplicates. Records of historical value lend themselves especially well to this treatment. For example, the original copy of the general ledger can be transferred to the records center for permanent retention when it is no longer needed in the office for reference—usually when it is two years old.

4. *Duplication of the original records.* This method calls for making an extra copy of a record in addition to the number needed for regular business purposes. It can be either a carbon copy, a photostatic copy, or a microfilm copy.

The Records Keeping System

After the records retention program has been completed, the inventory taken and evaluated, retention schedules established, and inactive records moved to the records center, attention should be directed to the records keeping system. This is the time, while current records are reduced in volume, to consider the efficiency of the filing system.

If the company files are badly disorganized and the filing system is inadequate, it may be desirable to employ a consultant who is a specialist in this field. If the consultant has been working on the prior phases of the program, undoubtedly attention will be given to records keeping problems.

There are too many systems and methods of filing to attempt an explanation of all of them but, in general, the list would include the following types of systems for filing records:

1. *Alphabetic.* The simplest and most frequently used; follows the alphabetical sequence.

2. *Numeric.* Filed by the number assigned to client, company, or special reference.

3. *Subject.* Most difficult; library-type classification under meaningful appropriate headings.

4. *Geographic.* Arranged according to the area, location, or territory.

5. *Chronologic.* Date order.

6. *Alpha-Numeric.* Permits a name against number check; the number is for machine accounting purposes; alphabetic for filing.

7. *Duplex-Numeric.* Controlled by a major number with sub-number.

8. *Decimal.* Used in the Dewey decimal or Library of Congress system.

9. *Soundex.* For reference to names sounding alike but spelled differently.

10. *Middle Digit.* For control where the volume by number is large; allows ease of expansion and filing.

11. *Terminal Digit.* The same principle as middle digit.

In addition to the company's general system there are special files maintained within a department according to the material to be filed, such as invoices, cancelled checks, remittance advices, expense accounts, etc. These special files may be placed in the centralized files or they may be located near the area where they are used depending on the frequency of reference to the records and the distance from central files to the area where they are to be used.

Forms Control

Another one of the distinct advantages of a detailed physical inventory is the systematic recording of all existing company forms. While taking the inventory, the form number and use are recorded. From this information an index of forms by number and function can be established. Duplications of forms will be apparent with an index control by function. It is recommended that the authority to originate forms be placed in one person who is trained to analyze their use and recommend the design, quality and type of paper to be used.

In addition to the need to control the plethora of forms there is an equally demanding necessity to give attention to the superabundance of carbon copies. This decision and control must perforce originate with management, since either the executive or his secretary makes a large contribution to this abundance of paper.

Personnel

The success of the records keeping system and records retention program will depend to large degree on the quality of the personnel employed. Well-qualified employees will generally recognize the need for a records control program and will competently implement the program. The concept that anyone can work with records and maintain them in an orderly fashion is a misconception. Special training, ability, and interest are necessary qualifications of a records administrator. Use of the following job description as a guide in selecting a records administrator who will be able to train and supervise the department's personnel is recommended.

A records administrator is well trained in records administration, has skill in instructing, skill in improving methods, and skill in working with people. He has a thorough knowledge of the field and the responsibilities involved. A records administrator collects information, recommends standard records practices and procedures, and submits them to management in the form of reports and memoranda. Through this means management is informed of the company's records situation and newer and better methods of operation.

To keep abreast of new trends in records management and to be informed of developments in related fields, the records administrator should visit other records departments and attend discussions of technical groups with similar interests. Membership in professional associations and extensive reading of technical literature in the records management field are important.

Those who possess a sound knowledge of records procedures, together with an imaginative appreciation of the intimate relationship between the management of records and the management of business as a whole, will be best fitted for this position.

A means available to management in the selection of records keeping personnel is the use of well-standardized aptitude, temperament and general intelligence tests. These results taken in conjunction with the applicant's interview, experience, and education place the selection of personnel on a scientific as well as personal basis. The choice of tests to be used should be made by the psychological agency administering them. Through the detailed job-description, the agency will give a battery of appropriate tests, interpret the results, and make a recommendation as to the applicant's qualifications for a particular job. The current rate for these services is small compared with the benefits of hiring qualified and interested personnel.

The crux of any system is the per-

sonnel. The best organized records program will remain so only as long as the people who maintain it are well qualified, well trained, and well supervised.

References

1. For a more detailed description of the method of taking an inventory, see William E. Benedon. "How to Inventory Records for Disposition," *The Office*, November 1957, pp. 8-28.

2. Appendix A to Title 1, "Guide to Record Retention Requirements," *Federal Register*, Part II, May 13, 1958, Volume 23, Number 94.

"Retention and Preservation of Records with Destruction Schedules," Record Controls, Inc., Chicago, Illinois.

3. "Case Studies in Records Retention and Control," prepared for Controllership Foundation, Inc., 1957. New York.

4. Robert A. Shiff, "Protect Your Records Against Disaster," *Harvard Business Review*, July-August, 1956.

Responsibility for "Other Data" in Long-Form Report

As a result of the presumption indicated in Statement No. 27 that an auditor, unless he states to the contrary, assumes responsibility for other data in the long-form report to the same degree that he does for individual items in the basic financial statements, i.e., that they are fairly stated in all material respects in relation to the basic financial statements, taken as a whole, a number of auditors have adopted the practice of explaining the extent of the examination made of data other than the basic financial statements and the degree of responsibility assumed therefor, if any. This follows the principle that an auditor should make clear what he does *not* undertake to do as well as what he *does* undertake to do.

In practice the auditor should approach his responsibility as to the "additional data" included in a long-form report with a good deal of caution. While much of the material may have been subjected to the audit procedures applied in the examination of the basic financial statements, experience with long-form reporting brings to mind a number of areas requiring critical appraisal of the adequacy of auditing procedures applied and of the need for a careful delineation of the extent of responsibility assumed. For example, a detailed schedule might include departmental operating figures which have been taken from company records in cases where tests of the income statement were made on an over-all basis only. These figures might include certain allocations of costs and expenses among departments made by management on a somewhat arbitrary basis, such allocations having no effect upon the income statement included in the basic financials. In such a situation, the auditor might wish to expand his procedures so that he could assume responsibility for such data, and the client might so request; or the auditor might choose to state that such data were not subjected to the audit procedures applied in the examination of the basic financial statements, in which case he should make clear his source of information and the extent of his examination and the responsibility assumed, if any.

Bert Rush, "The Implications of Statements No. 23 and No. 27 on Long-Form Reports," The Arthur Young Journal, July 1958

New York State Tax Forum

Guest Editor—Miriam I. R. Eolis, CPA

With the onset of a new season comes a revitalized stimulation of interest in what's been happening, what's new, and what's to come. The over-all picture—conflicts between federal and state approaches to tax statutes and regulations, overlapping and multiple tax levies among the states—this picture changes little and slowly. The particularities, however, create an endless need for inquiry and enlightenment.

Sick Pay Exclusion

Between the enactment of the 1954 Revenue Code and the amendment of the New York State Tax Law in 1957, the sick pay exclusion was a source of considerable conflict between federal and state handling of the problem. At one point, when the exclusion was allowable for federal income tax purposes, no deduction was allowed by the State. Then as a result of court decision an unlimited deduction was allowable by the State under a written plan for sick pay, while for federal purposes only $100 per week could be excluded and the plan could be unwritten. Finally, since January 1, 1957, the State law and regulations have been brought into conformity with the federal, and the same exclusion is now allowable under both.

Recently the State specifically ruled that, similar to the status under the federal regulations, the sick pay exclusion shall apply to wages received for the first seven calendar days of absence from employment, if the employee is hospitalized for at least one day of his illness. There is no limitation that the hospitalization must occur within the first seven days.

Non-Resident Credit

For many years, residents of the State of New York, who had income from sources within North Carolina, found themselves paying a tax on that income to both states, with no credit from either one. North Carolina has finally amended its income tax laws to provide for a non-resident credit similar to the one allowed under New York law. The war of the states is slowly but gradually coursing toward its end.

Exemption for Dependent Student

The New York Tax Law provides an exemption of $2,500 for a head of a family. To occupy the status of head of a family, a taxpayer must meet the statutory requirements of maintaining one or more dependents, whereupon he loses the $400 credit for the first such dependent, but acquires the head of family exemption. The laws of 1957 and

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Miriam I. R. Eolis, CPA, *formerly chairman of our Society's Committee on New York State Taxation and member of the Committee on Federal Taxation, is currently serving on the Committee on Estate Planning. Mrs. Eolis is a partner in the firm of A. L. Eolis & Associates, Certified Public Accountants.*

Ed. Note: For an interim period, until a permanent departmental editor has been selected, this department will be conducted by guest contributors.

1958 were amended to confer upon taxpayers a dependency credit of $800 for those dependents who continue their schooling beyond high school. Now the question arises, if a head of a family has only one dependent, a college student, as to how much credit, if any, he is entitled for the dependent. A few months back, one of my predecessor guest editors commented on this provision, and indicated that the taxpayer might be entitled to a $400 dependency credit in addition to the $2,500 head of family exemption. The Tax Commission has since ruled that no credit will be allowed for the dependent who affords head of family status, despite the fact that such dependent would otherwise qualify for the $800 credit. The ruling goes on to state that if the head of family has two dependents, one qualifying for $400 credit and the other for an $800 credit, one credit of $800 will be allowable. Furthermore, the ruling holds, if the head of family has two dependents, both of whom qualify for an $800 credit, one credit of $800 will be allowable. The ruling seems to be logical in the framework of the present law, and if any further relief is desirable it should be obtained by amending the statute.

Engaged in Real Estate

Operators of real estate under New York Tax Law are in favored tax positions. Individuals and partnerships solely engaged in real estate are exempt from unincorporated business tax. Corporations wholly engaged in real estate get the franchise tax benefits available under Section 182 of the Tax Law. Real estate operators, therefore, aim for the desired status of being solely or wholly engaged in real estate, while the taxing authorities seek to find them otherwise. There emerges the question, does wholly or solely engaged in real estate really mean 100 per cent engaged, or does it mean substantially engaged? For example, the Regulations state that the renting of furnished apartments constitutes a form of doing business, and not of engaging in real estate operation. Does it follow that if a real estate operator has fifty apartments, and rents one furnished and forty-nine unfurnished, his wholly engaged status is impaired, or should the rule of reasonableness prevail? The Tax Commission has been construing the statute strictly, and therefore ruling against taxpayers with any furnished apartments for rent. There are now a number of cases pending before the courts on this issue.

Sale of Stock of Cooperative Housing Corporations

Resident taxpayers who own stock in cooperative housing corporations are given, by statute, many of the tax benefits available to home owners; for example, the deduction of interest on mortgage, the deduction of real estate taxes, the deferment of gain on sale as if of a personal residence. Nonetheless, the Tax Commission has ruled that on a sale of the stock of the cooperative corporation the gain or loss is to be taxed as capital gain or loss, leaving the taxpayer in the rare position of "heads I win, tails you lose."

As to non-residents, they are ordinarily not subject to tax on gains from sale of stock. The Tax Commission has ruled, consistent with its ruling on residents, that non-residents shall not be taxed on the sale of stock in cooperative corporations unless the apartment owned is used for business.

Windfall Distributions

Under the 1939 Internal Revenue Code there emerged a series of cases, commonly referred to as the *Gross Morton* cases, wherein corporations mortgaged their real estate for more than

their cost of construction, and the moneys so received were distributed to stockholders. The courts held the distributions to be a return of capital, and subject to the capital gains tax provisions. The 1954 Code amended the law so as to make such distributions (subject to adjustments) taxable as dividends. The New York Tax Law has not been so amended.

There is now pending before the courts, under the New York Tax Law, the issue of whether a distribution by a corporation, not out of earnings and profits, shall be deemed a dividend distribution.

Tax Conformity and Uniformity

The constitutional amendment authorizing the use of federal net income as a basis for computation of state tax was passed in the last Legislature, and now awaits final confirmation. It will then remain to revise the State Tax Law to give meaning to the amendment. Achievement of a greater degree of conformity between federal and state tax laws will provide enlightenment to taxpayers, will be a boon to accountants, and will unravel much of the web of state tax administration.

If some measure of uniformity among the states can also be achieved, taxpayers can be relieved of many existing gross inequities. Many an individual has had to pay an income tax to his state of residence as well as to the state in which he earned his income. Many a corporation functioning in several states, pays overlapping taxes on the same income. Frequently, estate property has been subjected to an estate tax on the same assets by several different states. Multiple taxation makes for neither clarity nor good public relations. Many business, tax, and professional associations have put forth efforts to achieve interstate uniformity. Our Society, in the interests of equity for client taxpayers, as well as simplification of accounting in state tax matters, should join or initiate such efforts.

Professional Integrity

The accountant should seek to maintain his professional integrity in his association with an unaudited statement to the same degree as in an audit engagement. He should not place himself in a position where he might be identified directly or indirectly with any financial statement that he has reason to suspect is untrue. Where doubt exists as to the propriety of the statements the accountant should decline to act, unless the client permits an examination sufficient to remove the doubt.

Bulletin No. 13, Committee on Accounting and Auditing Research,
The Canadian Institute of Chartered Accountants, March 1957

Accounting at the SEC

Conducted by Louis H. Rappaport, CPA

Misleading Appraisal as Basis for Stop-Order

In the early days of the Securities Act the SEC prevented a substantial number of registration statements from becoming effective on the grounds that they contained misleading appraisal information. The SEC was not opposed to the use of appraisals, but it had a lot of experience with bad appraisals. Consequently many of the Commission's early decisions which led to the issuance of stop-orders were based on faulty appraisals.

As the Commission's views regarding appraisals became known and accepted, there was a gradual but noticeable decline in stop-orders based on faulty appraisals. They have not been entirely eliminated, however. As recently as June 1958, the Commission made public its decision in a case involving a stop-order and based its decision in part on the use of a misleading appraisal. (*In the matter of The Fall River Power Company*, Securities Act Release No. 3932, June 4, 1958.)

The registrant was a company that had been formed in 1910 and now owns properties in Colorado consisting of mining claims, tunnels, hydroelectric facilities and water rights. In 1944 a Mr. D acquired control of the company. Since their acquisition by Mr. D, the properties of the company have not been operated or active. The company filed a registration statement under the Securities Act. The proceeds of the offering were to be used to pay the company's debt to Mr. D and for exploration purposes.

The prospectus stated that the hydroelectric facilities were constructed in 1911 at a cost of $250,000 and that the appraised replacement cost of the facilities, at present-day levels, was $450,000. The prospectus also stated that the water rights were appraised at over $1,000,000 "by a competent civil engineer."

The civil engineer who made both appraisals, testified that although he had had experience in designing hydroelectric facilities he had never before appraised either hydroelectric facilities or water rights. He determined the replacement cost of the hydroelectric facilities by adjusting the original cost in 1911 for cost increases since that time. He stated that the figure of $250,000, represented to be the original cost in 1911, was based on records found by him in old files. Such figure was not itemized in any way, but purported to be a statement of expenditures by one

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Louis H. Rappaport, CPA, *a partner in the firm of Lybrand, Ross Bros. & Montgomery, CPAs, is the author of* SEC Accounting Practice and Procedure.

of the former owners and was taken by the engineer as a correct statement covering "the whole plant, the whole development." The engineer did not make any independent check or verification of the total cost figure or of the cost of any particular item in the plant. According to his testimony, he calculated that the cost of constructing the plant "today" would be about $750,000 based on the assumption that the dollar was worth three times as much in 1911 as it is today. However, he felt that $750,000 "seemed a little out of line," and compromised on a $450,000 figure. The basis on which the water rights were appraised at $1,000,000 was not stated in the registration statement and was not developed at the hearing before the SEC. At the hearing, however, counsel for the company conceded that the basis on which both the hydroelectric facilities and the water rights were appraised was insufficient to sustain the appraiser's opinion as to such value.

The SEC was highly critical of the methods employed by the appraiser and said:

"It is clear that in making his appraisal of the hydroelectric plant the engineer failed to follow any accepted appraisal techniques or norms and the appraisal was misleading in its implication that it was founded on a proper basis. Furthermore, the appraisal fails to take into account the registrant's present circumstances, including the lack of any outside demand for power which the plant might produce, and that no proven or probable ore has been established on the properties, and no consideration was given to the question whether it might be more economical for registrant to purchase from other public utility sources such electric energy as registrant may need in its activities than to restore and operate its own plant. It is to be noted that the plant was included in properties which [Mr. D] acquired in 1944 at an aggregate cost which he testified was about $100,000. Accordingly, we find the appraisal materially misleading.

"We also find, as admitted by registrant, that the appraisal of the water rights was not founded on any basis sufficient to sustain it, and we accordingly conclude that the use of that appraisal in the prospectus is materially misleading."

The hydroelectric facilities and the water rights appeared as assets in the financial statements at the amounts of the appraised values mentioned above. Having found these appraisals materially misleading, the Commission also said that their use in the financial statements was materially misleading.

The SEC said that generally accepted accounting principles require that assets ordinarily be recorded at cost. One of the exceptions to this rule occurs where the value of the property, through obsolescence or other cause, has declined materially below cost. The water rights were included in the properties which Mr. D acquired in 1944 for a stated total consideration of about $100,000, and "under the circumstances the acquisition by [Mr. D] established a new cost basis for the properties."

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, CPA

Sex, Adventure and Auditing

A well received novel, "The Accounting," treats of the "mysteries of an exacting profession," and centers about the search for evidences of a bank embezzlement. In the process of the investigation there are unearthed romantic (proper and improper) adventures which add a rare spice to an audit. The author, Bruce Marshall, was a chartered accountant in France prior to succumbing to the lure of fiction writing. Here he draws on his professional experience to furnish the cornerstone for a tale of sex, marital relations and adventure. The account of the investigation may also possibly furnish some good tips for internal control and audit programs.

Federal Government Record Retention Guide

Every accounting office should have a copy of the Federal Government's Record Retention Guide. It lists the requirements of each federal agency for the records that must be maintained by individuals, companies, fiduciaries, etc., who are within the province of each agency's jurisdiction, and indicates how long they must be preserved. Of particular interest to accountants, obviously, are the requirements of the Internal Revenue Service. However, other agency requirements, it will be found, will concern many accountants and their clients.

The guide constitutes Part 11 of the Federal Register of May 13, 1958 and it may be purchased for twenty-five cents from the Superintendent of Documents, Washington 25, D. C. Accountants will find the material useful in determining or revising their own record retention programs, but can also perform a valuable service for clients by advising them, where needed, of their record-keeping obligations.

Assembly Sheets and Explanatory Data For Tax Returns

Inadequacies in the procedural aspects of the preparation of business tax returns come home to roost and plague accountants when tax examinations are made. Then the difficulties of reconciling book figures with the tax return, reconciling tax and book earnings and surplus, explaining non-taxable income and non-deductible expense items, and other common deficiencies become evident. They increase the length of the

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MAX BLOCK, CPA *(N. Y., Pa.), is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.*

examination, irritate the examiner, may embarrass the practitioner before his clients and may even be costly tax-wise. Ordinarily, the time saved when the return is prepared is a very big price to pay for the time lost thereafter and for the other resultant difficulties.

The method of gathering the details for federal business income tax returns will vary with the size and complexity of the company, and will depend on whether a consolidated return is involved, the extent to which accounting and tax practices differ, and the usual individualistic differences of form and practice. Basically, the requirements are similar but the procedures may vary.

Here are a number of suggestions for the improvement of supporting records:

1. *An efficient data collection or grouping record.* This record could be the extended work sheet, or a separate tax work sheet which would readily disclose the combinations of book figures for placement in the income, balance sheet, schedule, and surplus sections of the tax return. This will facilitate the comparison of book with tax return figures.

2. *A reconciliation of net income per books and the tax return.* All differences must be supported by fully detailed explanatory data and data sources should be noted.

3. *Tax accounting details.* Where tax accounting and book principles vary, a permanent, cumulative and reconciling record of the tax accounting details should be maintained.

4. *Substantiating evidence.* Items of non-deductible expenses and non-taxable income must be covered by memoranda setting forth all the facts, and should be supported by law and case memos. and document references.

5. *Supporting schedules.* Permanent supporting schedules should be maintained for all surplus reserves, containing sufficient detail to relate the annual transactions to the records and to support them taxwise.

6. *Prior agreements.* Changes necessitated by prior tax examination agreements, which are not reflected in the records but which should be taken into account in the return under preparation, must be recorded, and the location of the Internal Revenue source report on which the changes are based should be noted.

7. *Explanations as to controversial items.* The existence and location of documentary and other supporting data for capital gain and loss items, casualty losses, capital redemptions and other changes, non-recognition of gains and losses, etc., should be noted. Memos containing explanations and the support for controversial items in the returns should be part of the tax return work papers.

8. *A tax file.* A good tax file should be maintained wherein the office copy of the tax return and the supporting papers are kept and become readily available when needed. The location of supporting papers not kept in the tax file should be noted therein unless clearly obvious.

Each of the foregoing requirements has its own procedural and form aspects and each will be discussed in later issues. Contributions of forms used by practitioners in any of these respects are solicited, as well as any other material relating thereto that may be of interest and help to practitioners.

Furnishing Adjusting and Closing Entries to Clients

In those cases where accountants prepare the adjusting and closing entries and submit them to clients, procedural problems exist which can be resolved by

organized, routinized measures. These procedures will vary materially where (a) the practitioner himself does the bookkeeping and would consequently make the journal entries directly, and (b) the entries are transmitted to the bookkeeper. The procedural aspects of the first category require no discussion; those of the second category do present several problems, namely, the timing, form, and follow-up measures to be taken.

The adjusting and closing entries, and the post-closing trial balance should be prepared on the job and turned in for review together with the report draft and work papers. Explanations of adjustments should be set forth fully and space considerations should not rule out the inclusion of any explanatory or supporting data.

As to the timing of the delivery of the entries, they must wait for the finalizing of the annual report. Who is to give the signal that the entries may now be sent out? One simple approach is to turn over the entries to the report typist together with the report draft. Automatically, the entries would be mailed together with the report. The reviewer could, if desired, advise that the entries be sent out prior to the report once the report is approved for typing.

Regarding the form of the entries, there are individual choices. A time-saving method is one where the entries are originally hand-prepared in duplicate and the copy is mailed to the client. Or, the original is on a type of paper which can be mechanically reproduced, thereby saving the typing and checking operation. These two methods present problems in legibility and perhaps neatness but, where costs are high and fees are modest, some compromise may be in order. However, by directed effort, the problems of legibility can be minimized.

Typing the entries is a practice that has the professional touch but it is time consuming and requires checking. In that form the entries could, perhaps more suitably than if written in long hand, be pasted by the bookkeeper into the journal and the ledger postings made therefrom. If convenient, the accountant should place the ledger account numbers next to the titles to facilitate the posting operation.

After the entries have been sent to the client the accountant should ascertain that they have been recorded fully and properly. A notation to this effect could be placed on the file copy or other appropriate record. If a post-closing trial balance is added to the adjusting and closing entries it will permit the bookkeeper to establish the correctness of the postings and facilitate the carry-forward of the opening balances. The mechanics of closing accounts and bringing forward balances ordinarily are understood by bookkeepers; otherwise instructions will have to be provided in person or in written form.

Payroll Tax Notes

Conducted by Samuel S. Ress

Some Recent Unemployment Insurance Decisions

Three recent decisions of the Unemployment Insurance Appeal Board deal with the law on voluntary leaving of employment, or discharge provoked by employee. In Appeal Board Case No. 63,800-58, a discharge because of a failure to shape-up constitutes voluntary leaving of employment where such method of assigning work is the employer's established policy and had in the past generally assured the claimant of steady employment. The Appeal Board disregarded the rule laid down in *Matter of Marcus*, 278 App. Div. 1037, that the disqualification for voluntary leaving of employment without good cause could not be sustained where claimant was a "shape-up driver," whose tenure of employment upon shape-ups was uncertain and speculative. The claimant in the present case had a prior reasonably steady pattern of employment with the employer.

In Appeal Board Case No. UCV510-5046-58R, the claimant had been employed while attending college as an assistant bookkeeper, as a salesman in a department store and as a book salesman in addition to part-time employment two or three nights a month as a taxi-driver for which he shaped up. After graduation from college, the claimant refused to continue "shaping-up" for employment as a taxi-driver. The Appeal Board upheld the right of claimant to discontinue seeking employment as a taxi-driver without being disqualified for the 42-day period provided in the law. In this case the Appeal Board felt that the claimant's other efforts to obtain employment in his chosen field were reasonable and diligent. Again, the Appeal Board disregarded a court decision in *Matter of Pillersdorf*, 278 App. Div. 59. In its opinion the Appeal Board stated: ". . . We believe that the Court did not intend to hold that a pèrson who accepts incidental part-time work, which is sporadic in nature while pursuing a course of study leading to a degree in a profession, must continue indefinitely in such employment or suffer disqualification."

Where a superintendent refused to continue collecting rents in five buildings where he had been employed because he feared personal harm might come to him or members of his family in case of hold-up, the collections being only from those tenants who did not pay their rent directly to the managing agent or the landlord, the Appeal Board, in Case No. 64,752-58, held that the superintendent provoked his discharge by refusing to perform what they con-

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Samuel S. Ress, *an associate member of our Society since 1936, is a member of the New York and Massachusetts Bar. He is engaged in public practice in his own office in New York City specializing in payroll taxation and labor-management matters.*

Dr. Ress is a member of the Society's Committee on New York State Taxation and chairman of its Subcommittee on Unemployment Insurance.

sidered was an integral part of the job, and upheld the determination disqualifying him from receiving benefits for 42 consecutive days from the day claimant filed his application for benefits.

Penalty for Claimant's Misrepresentation

Benefits of a claimant determined to have been guilty of a wilful false statement or representation to obtain any benefit under the provisions of the Unemployment Insurance Law, may be reduced pursuant to Section 594. In the cases heretofore discussed, the benefit rights of claimants were suspended for the periods of time set forth. After the running of the disqualification or suspension period, as the case may be, the claimant may collect the maximum amount of benefits provided in the statute, presently 39 weeks benefits in a benefit year. Under Section 594, however, as a result of the imposition of the wilful misrepresentation penalty, the claimant may be required to forfeit from 5 to 20 weekly benefit checks with respect to each offense following discovery of such offense. The penalty herein provided shall not be continued beyond two years from the date on which the offense was committed. A claimant is required to refund all moneys received because of such false statement or representation.

New Withholding Tax Regulations

The Commissioner of Internal Revenue has announced that "Final Regulations on Separate Accounting for Collected Taxes" (Regulation Section 301.7512-1), promulgated pursuant to the new Section 7512 of the Internal Revenue Code enacted last February, have become effective as of June 30, 1958. The Directors of Internal Revenue have new authority to deal with employers who fail to pay into the U. S. Treasury taxes withheld from their employees, or collected from their customers in the case of some excise and admissions taxes. Provision is made for separate accounting and monthly remittance. Failure to comply can result in criminal misdemeanor charges against a delinquent employer carrying penalties of up to a year in jail or a fine of $5,000. These penalties apply where the delinquent employer, after notice is served on him, fails to deposit withheld taxes within two banking days after collection in a separate bank account in trust for the United States.

Qualified Opinions

When a CPA believes the statements are a generally fair presentation, but he has not been completely satisfied on some point, or he feels that some part of the financial position or results of operations is not fairly presented, he may express a qualified opinion and indicate the nature of the reservation or exception. In general, the necessity for expressing a qualified opinion occurs when the CPA has not been permitted or was otherwise unable to make an examination sufficiently complete to warrant the expression of an unqualified opinion, or when he has found departures from accepted accounting principles which the company is unwilling to correct. Where a significant change has been made in the application of accounting principles the CPA qualifies his opinion as to the consistent application of generally accepted accounting principles. If he approves the change, he usually so states. Where possible, the CPA indicates the materiality of certain types of qualifications.

from 40 Questions and Answers about Audit Reports, AICPA, 1956

Federal Income Taxation

Decisions and Rulings — RICHARD S. HELSTEIN, CPA

Commentary — Committee on Federal Taxation
Chairman, HERBERT M. MANDELL, CPA

Decisions and Rulings

Transfer of Patent Rights

Section 1235, IRC 1954, provides for capital gain treatment of the sale or exchange of patent rights, regardless of whether the payment therefor resembles "royalties," if certain qualifications do not apply. (Since this section applies only to years commencing after January 1, 1954, Congress enacted a similar provision covering the years 1950 through 1953 by adding section 117(q) to the 1939 code.) Among the interdictions which would make this section inapplicable is the provision that the sale or exchange cannot be between related persons as defined in Section 267(b) except brothers and sisters. This particular prohibition operates to cause one of the most common types of transaction to fall without this relief provision, i.e., the transfer of patent rights to a corporation controlled directly or indirectly by the transferor.

In *Leonard Coplan* (1957, 28 TC 1189), the Tax Court held that the transfer of a patent to a family-owned corporation in exchange for royalties resulted in capital gain notwithstanding the non-applicability of Section 117(q). The *Coplan* decision was one of a series of decisions adverse to the Commissioner, commencing with that of *Edward C. Myers* (1946, 6 TC 258) in which the Commissioner had announced his non-acquiescence.

In a Technical Information Release (TIR 81, 6/27/58), the Commissioner has announced a change of policy and now acquiesces in *Coplan* and the prior decisions. The announcement states:

> The Service will . . . no longer take the position, in litigation or administratively, that the mere retention of an interest resembling a royalty by the assignor or transferor of a patent, in a transaction which otherwise has the characteristics of a sale but does not come within the purview of Section 1235 of the Internal Revenue Code of 1954 or of Section 117(q) of the Internal Revenue Code of 1939 in and of itself prevents capital gain treatment.

In reading this, however, it is well to bear in mind that this does not provide carte blanche for any and all assignments. It only provides that because a transfer or sale does not fall within the relief sections of the Code, it does not *necessarily* result in ordinary income. It is still necessary to establish a bona fide sale or transfer of all substantial rights to the patent.

Permanent Auxiliary Records

Regulations 1.167(a)-7 provide that where depreciation reserves for tax purposes differ from those maintained for book purposes, permanent auxiliary

records must be maintained reconciling the differences in depreciation for tax and book purposes (occasioned by different methods of depreciation, bases of assets, rates, salvaging, or other factors).

The Commissioner has ruled that work sheets do not meet this requirement. He has further ruled that the reconciling records must be kept at the same place as the regular books of account. Therefore, the practice of maintaining work sheets or reconciling records at the office of independent public accountants is not considered as compliance with this requirement. (Rev. Rul. 58-305, IRB 1958-25, 15.)

While this requirement appears in the Regulations dealing only with depreciation, it is authorized by Section 6001, IRC 1954, which gives blanket authority to the Commissioner to require any person to keep such records as the Commissioner may deem necessary to reflect the correct tax liability.

There are many cases (indeed volumes have been written on this subject) of differences in tax accounting and accepted principles of accounting. Thus, most taxpayer's books of record which are kept in accordance with accepted principles of accounting differ from the tax treatment of many items recorded therein. For example, there are differences in the bases of assets; in the recording of goodwill, patents and organization expenses (which are often written down to $1.00 for book purposes); reserves for bad debts; experimental and development expense; and circulation expenditures. Since the repeal of Sections 452 and 462 there is also a difference in the treatment of income received in advance and estimated expenses.

With respect to many of the above items, no regulations have yet been finalized; with respect to others, no provision for auxiliary records is mentioned in the regulations. However, under the blanket authority delegated to the Commissioner by Section 6001, he may at any time issue rulings requiring such auxiliary records. It is foreseeable that some time in the future it will be necessary for a taxpayer to maintain two sets of books—a practice which in the past has sometimes been associated with notoriety and fraud proceedings.

Suits for Refund

The Supreme Court has ruled that a taxpayer must pay the full amount of an income tax deficiency before it can bring a suit for refund in the District Courts. Reviewing the history of pertinent legislation, the Court decided that it was clearly indicated that Congress approved and did not attempt to alter this doctrine, which was promulgated in 1875 in *Cheatham* v. *U. S.* 92 U.S. 85. (*Flora* v. *U.S.* 6/16/58 —— U.S.——.)

Charitable Contributions of Individuals

In a series of rulings, the Commissioner has sought to clarify his position as to certain types of charitable contributions.

The fair market value of an undivided interest in real property, donated by the owner to any qualified organization (see Section 170(c) IRC 1954), is deductible as a charitable contribution within the limitations of Section 170 of the 1954 Code. The deduction will be allowed in the year in which the interest is transferred. Royalties or rents

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RICHARD S. HELSTEIN, CPA, *has been a member of our Society since 1940. He is a member of the Committee on Federal Taxation and of the Committee on Publications. Mr. Helstein is associated with J. K. Lasser & Co.*

collected by the donee in subsequent years on the portion of the property transferred are income to the donee, not the donor, and therefore are not contributions by the donor in such years. If all or part of the donor's remaining interest in the property is contributed in a subsequent year, the donor will be entitled to a deduction to the extent of the fair market value of the portion donated computed in the year of the subsequent donation. (Rev. Rul. 58-261, IRB 1958-22, 12.)

The purchase of building bonds issued by a church is *not* a charitable contribution deductible under Section 170. However, if subsequently the bonds are donated to the church, the taxpayer will be entitled to a deduction in the year of the donation of the bonds. (Rev. Rul. 58-262 IRB 1958-22, 12.)

An outright contribution to the fund, where no property of value is received in exchange, is apparently deductible in the year paid.

Deductible contributions to an organization dedicated to the welfare of animals held for medical research is subject to the 20 per cent limitation of the donor's adjusted gross income under Section 170(b)(1)(B) and does not qualify for the additional 10 per cent under Section 170(b)(1)(A). (Rev. Rul. 58-263, IRB 1958-22, 13.)

Contributions by clergymen to a pension fund administered by the church for their benefit or for the benefit of their surviving family are not deductible under Section 170. Such contributions are non-deductible personal expenses under Section 262 (Rev. Rul. 58-264, IRB 1958-22, 14.)

Commentary

Security Sales to Family Members

It has been the practice for some time now for taxpayers to sell appreciated securities to charitable organizations at the seller's cost. The Internal Revenue Service has ruled that the seller need not pick up any profit on the transaction and is entitled to a contribution deduction for the excess of the fair market value of the securities over the price at which they are sold to the charity.

Tax advantages may result from similar transactions with family members. High-bracket taxpayers have often tried to assign income to a low-bracket trust or child while retaining the principal for himself. This cannot ordinarily be done except through the use of a trust which diverts the income to the low-bracket taxpayer for a period of at least ten years, after which the principal can return to the grantor. The diversion-of-income prohibition is not, however, applicable to capital gains. Regulation Section 1.1001-1(e) clearly indicates that a taxpayer may sell a security on which he has appreciation to a member of his family *at his cost* without realization of profit by him. According to Regulation Section 1.1015-4, the transferee's basis will be the amount paid to the transferor, and the profit on the security will be taxable to the transferee when the security is sold. The effect of the transaction is to shift the tax on the profit from the high-bracket transferor to the low-bracket transferee.

The tax advantage resulting from the shift is generally limited to short-term capital gains. It would rarely apply to long-term capital gains, because the transferee's holding period would begin on the date of acquisition and the transferor's holding period would be lost. The transferor's long-term gain, subject

to a maximum tax of 25 per cent might be converted into a short-term gain for the transferee taxable at ordinary rates. Long-term gains may, however, be advantageously transferred if the transferee has deductions or exemptions which would otherwise be wasted.

As in any other intra-family transaction entered into to save taxes, scrupulous care must be taken to be sure that the transaction is in substance what it appears to be in form. All of the requirements and attributes of a sale must be carefully observed, or the Internal Revenue Service might take the position that the sale by the transferee was made as agent for the transferor so that the profit would be taxable to the latter. Of course, the sale to the family member at less than value results in a gift from the transferor to the transferee, subject to the same annual exclusions and lifetime exemption as in the case of any other gift.

Deductions "In Respect of a Decedent"

Section 691(b) of the Internal Revenue Code allows as an income tax deduction business expenses, interest, taxes, "non-business expenses," and depletion, in respect of a decedent, which are not properly allowable to the decedent for the tax period in which his death occurs, or for any prior period. Upon payment, this deduction is allowed on the income tax return of the estate of the decedent or to any other person who by bequest, devise, or inheritance acquires property subject to the obligation to pay these amounts. For example, take the case of a decedent who, prior to his death, had incurred business expenses, but had not taken an income tax deduction for these items because he filed his income tax returns on a cash basis and they had not been paid prior to the date of death. These accrued Section 691(b) items, when paid, may be taken as a deduction by the decedent's estate or beneficiary who assumed the obligation and made the payment.

The obligation of a decedent for the payment of business expenses, interest, taxes and other items set forth above, incurred prior to death, but unpaid at the date of death, would also be allowable as a deduction in calculating the federal estate tax. These items would be designated "claims against the estate" and as such would be deductible under Section 2053.

The allowance of this double deduction (on both the income and estate tax) for such items may produce unexpected results. It is possible, for example, that where the combined income and estate tax rates of an estate which pays any of these accrued Section 691(b) deductions exceed 100 per cent, the payment of such items will result in actual tax savings in excess of the amount disbursed in payment of the debt. It should be noted, however, that the double deduction items of Section 691(b) must be offset against the doubly taxed income items of Section 691(a) in determining the deduction

for estate taxes paid on income in respect of the decedent provided for in Section 691(c).

A Section 691(b) deduction must be distinguished, however, from the deduction for an administration expense incurred and paid by an estate. The latter deduction can be taken, at the election of the executor, on either the estate tax return or on the fiduciary income tax return, but not on both (Section 642(g)).

Election to File Consolidated Returns

It is frequently assumed that the acquisition of a new subsidiary will provide a new election to file consolidated returns. This is not always so because it is necessary that the acquisition of the new subsidiary take place while the old group is in existence. A hypothetical example will illustrate the rule.

Corporation P and its wholly owned subsidiary, Corporation A, have consistently filed calendar year consolidated returns. Corporation P sells all the stock of Corporation A on August 21. On September 1 Corporation P acquires 100 per cent of the stock of Corporation B. Must Corporation P file a consolidated return with Corporation A for the period they were affiliated from January 1, 1958 through August 21, 1958, or does the old group have a new election?

The affiliation of the new subsidiary, Corporation B, would permit a new election only if the consolidated group were in existence at the time of B's acquisition. In an informal ruling, the Internal Revenue Service in Washington has interpreted Regulation Section 1.1502-11(a) in this way on the basis of the phrase "has become a member of the group." If the affiliation of Corporation B took place before August 21, then Corporation B would have become a member of an existing affiliated group, whereas affiliation after August 21 was with Corporation P which, at that time, was not part of an affiliated group.

The reasoning is that the affiliated group of Corporation P and Corporation A terminated on August 21, since at that point Corporation P ceased to have a subsidiary affiliated with it, in accordance with Section 1.1502-11(d) of the Regulations. Therefore, since a consolidated return was filed for the calendar year 1957, one would be required from January 1, 1958 through the date in 1958 when the affiliation terminated. The fact that Corporation P acquired a new subsidiary in 1958 does not mean the old group is entitled to a new election, because there was a period during 1958 when Corporation P had no subsidiary.

Corporation P and Corporation B constitute another affiliated group which may or may not elect to file a consolidated return for the portion of 1958 during which they are affiliated. If Corporation P does not file a consolidated return with Corporation B, the consolidated return of Corporation P and Corporation A must include Corporation P's income for all of 1958 in accordance with Sections 1.1502-13(b) and (c) of the Regulations.

The above indicates that timing of the disposition of a subsidiary may be important.

Disposition of "Section 306 Stock" in a Recapitalization

Section 306(a) provides that the amount realized upon disposition of "Section 306 stock" shall be treated as gain from the sale of property which is not a capital asset. Further, if the disposition is a redemption, the distribution is taxed as dividend income to the extent of the earnings of the corporation. An exception to this general rule is provided in Section 306(b)(3) to the extent that gain or loss is not recognized to the stockholder in the transac-

tion. A recent problem involved the question of whether a non-taxable recapitalization, coming within the exception of Section 306(b)(3), occurs in the event one preferred stockholder (as opposed to all of the preferred stockholders) exchanges Section 306 stock for common stock.

During the previous two years, a corporation issued in a recapitalization two shares of new common stock and one share of new preferred stock in exchange for one share of the old common stock. The preferred stock is considered Section 306 stock. Subsequent thereto, a corporate officer who had an 8 per cent common stock interest proposed that the corporation issue to him additional common stock in exchange for his preferred stock.

In an informal opinion, the Internal Revenue Service stated that, if the corporation made the exchange offer *available* to all preferred stockholders, the Service would rule that there was a recapitalization. Further, since under Section 354, no gain or loss would be recognized in the recapitalization, this exchange would be an exception to the general rule under Section 306(b)(3), *even if the offer of exchange were accepted by only one person.*

Under Section 368, any tax-free reorganization requires a business purpose. It was stated at the informal conference that the business purpose requirement for these "little recapitalizations," involving Section 306 stock, would be liberally construed. For example, if the Section 306 stock may be called at the option of the corporation at a certain date, the business purpose requirement might be satisfied by the fact that the use of common stock would permit the corporation to conserve cash that would otherwise be used to redeem the outstanding preferred stock.

Deferred Payment Sale Not Qualifying as Installment Sale

A cash basis taxpayer selling a capital asset at a gain may receive too high a down payment to qualify for the installment method of reporting. In certain circumstances, however, other tax deferral methods are available which may even be more advantageous.

The Tax Court has held that if the consideration for the sale is an oral contract or an unsecured written contract, a cash basis seller may report the gain only when the cash payments exceed basis because such contracts are not considered the equivalent of cash. (*N. J. Ennis*, 17 TC465(1951) and other decisions following this case.)

For example, a capital asset with a basis of $10,000 is sold under an unsecured contract with a down payment of $10,000 and $2,000 annually for five years. In the year of sale there is no gain, and in each subsequent year there is a $2,000 capital gain. If the down payment was less than cost, the profit would begin to be taxable in the year the payments exceeded the basis.

Suppose, however, that the balance of $10,000 in the above example is secured by a purchase money mortgage. If the facts permit, the mortgage is valued on a discounted basis in computing the total sale price. Thereafter, as the mortgage payments are made, that portion of each installment which represents discount is taken into income. If the purchaser is not a corporation, this discount is ordinary income. However, if the purchaser is a corporation, under Section 1232, the discount may be treated as capital gain, providing the mortgage is a capital asset in the seller's hands.

Effects of Attribution Rules Under Section 304

Under Section 304(c) if 50 per cent or more of the stock of one corporation

is owned by another corporation, it is considered as being controlled by the other corporation. Furthermore, under Section 318(a)(2)(C), a corporation is considered as owning the stock owned by a shareholder owning 50 per cent or more of its stock. However, for the purpose of Section 304, this 50 per cent requirement is eliminated. Therefore, under Section 304, a corporation is treated as owning all of the stock owned by *any* of its shareholders.

Section 304 provides that if one corporation acquires stock of another corporation, which controls the acquiring corporation, and the acquisition is from a shareholder of the controlling corporation, the consideration is treated as a redemption of the controlling corporation's stock. Therefore, the payment received by the shareholder is subject to possible treatment as an ordinary dividend distribution. This rule may produce some weird results.

Suppose that Mr. Jones owns 100 per cent of the stock of X Corporation which has a substantial surplus. He also owns 10 shares of A. T. & T. stock which he sells to X Corporation at its fair market value. Applying the above rules literally, A. T. & T. would be deemed to own 100 per cent of the stock of X Corporation. Consequently, the purchase by X Corporation could be treated as the acquisition by a subsidiary of its parent corporation's stock from a shareholder of the parent, and accordingly be considered as a redemption by A. T. & T. of its own stock. It is therefore possible, although very unlikely, that the Internal Revenue Service might attack the sale as a dividend distribution by A. T. & T.

Section 304 deals with redemptions by "sister" corporations as well as "parent-subsidiary" redemptions described above. Applying the attribution rules in the same way as in the example, however, results in all "sister" corporations controlling one another and coming within the "controlling-controlled" corporation rules.

It should be noted that the Subchapter C Advisory Committee to the House Ways and Means Committee has recommended changes in Section 304 which would eliminate the problems outlined above.

Responsibility for Fairness of Statements

Financial statements are primarily the statements and representations of the company. The fact that they have been examined and reported upon by a CPA does not shift the company's responsibility for the fairness of the information presented.

The transactions with which the accounting records are concerned, and the recording of those transactions in the books, are matters within the direct or primary knowledge and control of the company. While the CPA may supervise the keeping of the records, and often prepares the financial statements, his knowledge of the transactions is a secondary one. Thus, even though the financial statements may reflect the influence of the CPA, the company in presenting them to others must be considered to have accepted, and adopted, the CPA's recommendations. The company cannot be excused for presenting statements which it knows to be false or misleading any more than can the CPA.

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